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Interactive Self-study CPE

Companion to PPC's Guide to HUD Audits

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INTRODUCTION

Companion to PPC's Guide to HUD Audits consists of three interactive self-study CPE courses. These are companion courses to *PPC's Guide to HUD Audits* designed by our editors to enhance your understanding of the latest issues in the field. *PPC's Guide to HUD Audits* as well as other PPC products are available for purchase at **tax.tr.com/ppcguidance**.

To obtain credit for this course, you must complete the learning process by logging on to our Online Grading System at **cl.tr.com/ogs** or by emailing, faxing, or mailing your completed **Examination for CPE Credit Answer Sheet** for print grading by **November 30, 2023**. Complete instructions for grading are included below and in the test instructions preceding the **Examination for CPE Credit**.

Taking the Courses

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CPE requirements are established by each state. You should check with your state board of accountancy to determine the acceptability of this course. We have been informed by the North Carolina State Board of Certified Public Accountant Examiners and the Mississippi State Board of Public Accountancy that they will not allow credit for courses included in books or periodicals.

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COMPANION TO PPC'S GUIDE TO HUD AUDITS

COURSE 1

HUD BASICS AND CONCLUDING A HUD AUDIT (HUDTG221)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course provides an overview of HUD programs and participants, as well as guidance for concluding a HUD audit. Lesson 1 discusses HUD's organization and various programs, identifies participants in HUD programs, and presents the standards applicable in audits of HUD-assisted entities. Lesson 2 details matters related to concluding a HUD audit, such as going concern considerations, written representations, the exit conference, and client communications.
PUBLICATION/ REVISION DATE:	November 2022
RECOMMENDED FOR:	Users of *PPC's Guide to HUD Audits*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of governmental auditing
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's *Government Auditing Standards*.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by **November 30, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—HUD Basics

Completion of this lesson will enable you to:

- Describe the types of HUD multifamily housing programs, the functions of various HUD offices, and participants in HUD programs.

- Identify the guidance applicable to and the accountants' involvement in audits of HUD-assisted entities, and steps in the PPC audit process.

Lesson 2—Concluding a HUD Audit

Completion of this lesson will enable you to:

- Identify methods for addressing commitments and contingencies, accounting estimates and fair value, subsequent events, and related parties in HUD engagements.
- Recognize going concern considerations and the written representations needed in a HUD audit.
- Determine how to address the accumulated results of audit procedures, analytical procedures, workpaper review, and summarization and evaluation tasks.
- Recognize best practices for drafting financial statements and the auditor's report, the exit conference, required communications, finalizing and retaining workpapers, and addressing matters discovered after the report date.

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Lesson 1: HUD Basics

INTRODUCTION

The U.S. Department of Housing and Urban Development (HUD) sponsors a broad range of programs designed to revitalize urban neighborhoods, stimulate housing construction, encourage home ownership opportunities, and provide decent, safe, and affordable housing. The programs are primarily directed toward low and moderate income families. They are carried out through various forms of federal financial assistance, including entitlements, grants, direct loans and advances, subsidies, risk-sharing programs, and mortgage insurance. Depending on the particular program, recipients of the federal aid may be units of local government, such as states, cities, or counties; public housing authorities that develop, own, or operate housing projects; other profit motivated or nonprofit builders, developers, or owners of housing projects; mortgage lenders; or individuals. Examples of HUD program categories are Community Development Block Grants and single, multifamily, public, and Indian housing programs.

This course focuses on HUD-assisted multifamily housing projects owned by business entities (for-profit entities) and nonprofit entities. The objective is to assist auditors of HUD-assisted multifamily housing projects in auditing the financial statements in accordance with both generally accepted auditing standards and generally accepted government auditing standards and reporting on the entity's compliance with laws and regulations affecting HUD-assisted programs. This course also provides guidance about the accounting and financial statement presentation issues that are common for HUD-assisted projects.

Although outside the scope of this course, *PPC's Guide to HUD Audits* provides some limited guidance for auditors of nonsupervised and supervised lenders that participate in FHA insurance programs and also provides limited guidance to auditors about the Low-Income Housing Tax Credit (LIHTC). The LIHTC is a federal income tax credit administered by the states that was established to encourage and finance new construction and rehabilitation of existing housing for low-income households. *PPC's Guide to HUD Audits* provides an overview of the LIHTC regulations, explains the services that auditors may provide for these projects, discusses compliance issues related to ongoing and initial project completion, and illustrates independent accountants' reports for LIHTC projects.

This lesson provides an overview of the following topics:

a. HUD's multifamily housing programs.

b. HUD offices that are important to auditors.

c. Participants in HUD's programs.

d. Audit and accounting guidance applicable to owners of multifamily housing projects that receive assistance from HUD.

e. Accountants' involvement with HUD clients.

f. The PPC risk assessment process.

Learning Objectives:

Completion of this lesson will enable you to:

- Describe the types of HUD multifamily housing programs, the functions of various HUD offices, and participants in HUD programs.
- Identify the guidance applicable to and the accountants' involvement in audits of HUD-assisted entities, and steps in the PPC audit process.

CATEGORIES OF MULTIFAMILY HOUSING PROGRAMS

Most of HUD's multifamily housing programs can be classified into the following broad categories:

a. Multifamily mortgage insurance.

b. Coinsured loans.

c. Risk-sharing programs.

d. Direct loans, capital advances, flexible subsidies, and grants.

e. Rental subsidies.

HUD programs are established by housing legislation. Thus, many HUD programs are identified by a number that refers to legislation under which the program was enacted. For example, the legal authority for Section 8 rental subsidy programs is Section 8 of the U.S. Housing Act of 1937. HUD programs are implemented through regulations, which are found at Title 24 of the *Code of Federal Regulations*.

From an auditor's perspective, knowing what type of HUD program each multifamily housing project operates under is important because accounting considerations and specific auditing and compliance procedures can vary by program type. The following discussion provides an overview of the principal types of multifamily housing programs.

Insured Loans

HUD administers several mortgage insurance programs that provide insurance to lenders to encourage them to make loans to developers and builders who construct or rehabilitate multifamily housing projects. Depending on the particular program, loan proceeds may be used to finance the construction of new housing or acquire or rehabilitate existing housing. Under the programs, HUD insures lenders against loss on a mortgage if a borrower (project owner) defaults during the life of the mortgage loan. If the borrower defaults, the lender can assign the mortgage to HUD, making HUD responsible for servicing. HUD can also take legal action to take possession of the property and become the owner.

The principal HUD multifamily mortgage and loan insurance programs are as follows:

- Section 207 Multifamily Rental Housing
- Section 207 Manufactured Home Parks
- Section 213 Cooperative Housing
- Section 220 Urban Renewal Projects
- Section 221 Multifamily Rental Housing for Low and Moderate Income Families
- Section 223(f) Purchase or Refinancing of Existing Projects
- Section 223(a)(7) Refinancing of Existing Projects
- Section 231 Housing for the Elderly and Handicapped
- Section 232 Nursing Homes, Assisted-Living Facilities, and Intermediate Care Facilities
- Section 234(d) Condominium Housing
- Section 236 Interest Reduction Program
- Section 241(a) Insured Supplemental Loans on Multifamily Housing Projects
- Section 242 Hospitals

Some insured loan programs are targeted for low and moderate income housing, while others are designed specifically for elderly or handicapped persons.

Coinsured Loans

Housing legislation enacted in 1974 authorized HUD to coinsure mortgages with approved coinsuring lenders. The objective of the coinsurance programs was to facilitate the efficient processing of mortgage applications. Under the programs, the coinsuring lenders agreed to abide by HUD's requirements, to perform HUD's normal loan underwriting functions, and to share a portion of the risk of loss. Many project owners and coinsuring lenders were unable to honor their financial obligations, however, causing HUD to sustain large losses. As a result, HUD terminated its coinsurance programs in 1990.

Although coinsured mortgages are no longer made, HUD continues to service coinsured mortgages underwritten prior to November 12, 1990, and mortgages to protect owners whose applications were in process but had not been approved as of that date. Subsequently, multifamily housing mortgages are underwritten by HUD staff with limited use of "delegated processing" to private sector mortgage companies.

Risk-sharing Programs

The multifamily risk-sharing program is designed to encourage the production of affordable rental housing by allowing HUD to provide risk-sharing arrangements to state and local housing finance agencies. Created under Section 542 of the Housing and Community Development Act of 1992 (also called the Multifamily Housing Finance Improvement Act), the insurance program was created to demonstrate the effectiveness of providing new forms of credit enhancement for multifamily loans. A housing finance agency must be approved by HUD to participate in this program. To be eligible, the agency must be a HUD-approved multifamily mortgagee in good standing and meet other credit, experience, and management criteria.

Direct Loans, Capital Advances, Flexible Subsidies, and Grants

Section 202 Direct Loans. Under Section 202 of the National Housing Act of 1959, HUD was authorized to make long-term loans directly to multifamily housing projects. Loan proceeds were used to finance the construction of housing for persons age 62 or older and handicapped persons. In 1990, amendments to Section 202 replaced the direct loan program with "capital advance" programs for owners of housing designed for elderly or disabled residents. HUD continues to service direct loans that were made under the old Section 202 program.

All projects that received Section 202 direct loans also are eligible for assistance under HUD's Section 8 rent subsidy program.

Direct Loans under the Property Disposition Purchase Money Mortgage Program. In the 1970s, a direct loan program was established to facilitate sales of projects that HUD had previously acquired through foreclosure. Under the Property Disposition Purchase Money Mortgage Program, HUD would sell the property and take back a purchase money mortgage of up to 90% of the selling price. These projects were often provided with Section 8 rent subsidies. HUD no longer issues purchase money mortgages when selling properties in its inventory. It now sells such properties on a "cash only" basis.

Capital Advance Programs. HUD makes capital advances to nonprofit organizations for the construction, acquisition, or rehabilitation of housing for persons age 62 or older (under Section 202 of the Housing Act of 1959 as amended) or disabled persons (under Section 811 of the National Affordable Housing Act). Capital advances bear no interest and need not be repaid so long as the housing remains available to elderly or disabled persons for at least 40 years. Only nonprofit projects are eligible for assistance under capital advance programs. Capital advance projects are typically supplemented with rental assistance.

The American Homeownership and Economic Opportunity Act of 2000 includes amendments to the section 202 and 811 programs intended to facilitate the rehabilitation and preservation of these properties.

Flexible Subsidies. Two types of loans are available under HUD's flexible subsidy program—operating assistance loans and capital improvements loans. Both types of loans are generally made to projects with mortgages that are either insured or held by HUD. Operating assistance loans are made to projects that are experiencing operating deficits. They are designed to provide temporary funding to replenish project reserves, cover operating costs, and pay for limited physical improvements. Capital improvements loans are intended to assist projects with the cost of major repair and replacement of building components when project reserves are insufficient to fund the improvements.

Rental Subsidies

HUD rent subsidy programs provide financial assistance to low-income tenants of multifamily housing projects through payments that reduce the rent they pay. Under the programs, eligible tenants are only required to pay a portion of the market or HUD-approved rent, and HUD pays the difference on behalf of the tenants to the project owners. Not all units within a HUD project need be rent subsidized; depending on a tenant's income level, some units may be leased at market rate.

The largest rent subsidy program is authorized under Section 8 of the U.S. Housing Act of 1937. The "Section 8 Program" includes eight principal subprograms targeted toward different types of housing projects and tenants with different income levels. Other rent subsidy programs are (a) rent supplements, (b) rental assistance payments, and (c) project rental assistance under the Section 202 and Section 811 capital advance programs. Rental subsidies often accompany insured, direct loan, or capital advance programs.

HUD ORGANIZATION

HUD Headquarters

The Department of Housing and Urban Development—HUD headquarters—in Washington, D.C., administers all HUD programs nationwide. Much of the activity at HUD headquarters relates to HUD's administrative and legislative functions and, thus, does not directly concern auditors. However, auditors may interact with certain departments when auditing HUD projects or for practice development purposes. The departments of primary interest to auditors are discussed in the following paragraphs.

Office of the Inspector General (OIG). The HUD OIG is responsible for promoting the integrity, efficiency and effectiveness of HUD programs. It works to accomplish this by conducting audits and investigating charges of fraud, waste, and abuse in HUD programs. OIG's other responsibilities include the following:

a. Reviewing auditors' audit documentation to determine compliance with generally accepted auditing standards (GAAS) and generally accepted government auditing standards (GAGAS). Auditors subject to review are selected from referrals received from other HUD offices. Firms with significant numbers of HUD clients are more likely to be reviewed by the OIG.

b. Periodically updating HUD Handbook 2000.04, *Consolidated Audit Guide for Audits of HUD Programs* (the HUD audit guide) to reflect changes in HUD regulations, GAAS, and GAGAS.

The HUD OIG can seek administrative sanctions, civil recoveries and/or criminal prosecution of those responsible for waste, fraud and abuse in HUD programs and operations. A current directory of HUD's OIG offices is available on the OIG's website at **www.hudoig.gov/about/where-were-located**.

Office of Financial Services. The Office of Financial Services maintains loan ledgers, escrow accounts, and reserve funds for mortgages of HUD projects that are held by HUD. (HUD may hold the mortgage because the borrower defaulted on a HUD-insured mortgage and the lender assigned the loan to HUD for insurance benefits or because it directly issued the mortgage.)

Office of Housing Assistance and Grant Administration. The Office of Housing Assistance and Grant Administration administers the direct loan and capital advance programs for the elderly and disabled. As a result, that office maintains information concerning projects whose owners are in the process of applying for assistance under those programs. On request, it will send auditors information on prospective HUD projects in their locality, which auditors may use for practice development purposes.

Office of the Secretary. Within the Office of the Secretary, the office of greatest interest to auditors is the Mortgagee Review Board, which examines the conduct of mortgagees and loan correspondents who participate in HUD housing programs.

Office of Recapitalization. The Office of Recapitalization was created in 2014 to absorb the Office of Affordable Housing Preservation, the administrator of the Mark-to-Market program (M2M) after the legislative sunset of the Office of Multifamily Housing Assistance Restructuring (OMHAR). The M2M program was created to reduce the rents on expiring housing subsidy contracts to market levels and restructure existing debt to amounts that can be supported by these rents. In addition, the Office of Recapitalization oversees the Rental Assistance Demonstration Program (RAD) and the Section 236 Preservation Program.

Real Estate Assessment Center. HUD created its Real Estate Assessment Center (REAC) to centralize the assessment of all HUD housing. Its mission is to improve housing quality and assure the public trust by providing accurate, credible, and reliable assessments of HUD's real estate portfolio. It does this through physical inspections and financial assessments. REAC's financial assessment of multifamily housing programs is performed on the project's financial information electronically submitted through the FASSUB system. This centralized review ensures consistency of financial statement and supplementary information requirements among projects. In addition, REAC staff perform quality assurance reviews of auditor's workpapers. In these reviews, REAC staff visit auditor's offices across the country reviewing their audit documentation for conformance with professional standards, *Government Auditing Standards*, and HUD requirements. These reviews are similar to the IG reviews described above.

Departmental Enforcement Center. HUD also created the Departmental Enforcement Center (DEC) to take action against HUD-assisted entities that are responsible for waste, fraud, and abuse in HUD programs. The center receives referrals from the REAC of entities failing their financial or physical inspections. The center seeks remedies from the entities and works with the HUD OIG on criminal investigations.

HUD Field Offices

To administer HUD programs throughout the country, HUD has established state offices and area offices. The field offices have authority for the day-to-day oversight of HUD projects and for interpreting HUD requirements. Within each field office, the Asset Management Branch and the Mortgage Credit Branch are of particular importance. The Asset Management Branch controls releases from project reserve funds, conducts physical inspections of HUD projects, and reviews project accounting procedures and leasing practices. The Mortgage Credit Branch is responsible for reviewing "cost certifications" submitted by developers of HUD projects.

The field offices are organized into 10 geographic regions, each with a regional office. A "secretary's representative," assigned by the HUD secretary to each region, is responsible for ensuring that HUD policies developed in Washington are implemented throughout the country. A directory of HUD field offices is available at **www.hud.gov/program_offices/field_policy_mgt/localoffices**.

THE PARTICIPANTS IN HUD PROGRAMS

Project Owners

Form of Organization. In the authors' experience, approximately 70% of multifamily housing projects are owned by noncorporate entities—usually partnerships but, in a few instances, sole proprietorships. Approximately 25% of multifamily housing projects are owned by not-for-profit corporations provided tax exempt status under Section 501(c)(3) of the Internal Revenue Code. (The nonprofit projects are typically either owned by national nonprofit organizations, for example, the Salvation Army, or community based charitable groups, for example, the "Council of Presbyterian Churches of XYZ County.") The remaining 5% of HUD projects are organized as either C or S corporations.

Profit-motivated Projects versus Limited Distribution or Nonprofit Projects. Owners of HUD projects can be organized into three broad categories: profit motivated, limited distribution (also referred to as limited dividend), and nonprofit. For HUD regulatory purposes, the distinction between the three is based on whether the project owners are permitted to retain "surplus cash." *Surplus cash* is a regulatory term that essentially refers to cash in excess of that needed to meet all project expenses and reserve requirements. In the case of profit-motivated projects, all surplus cash generated by the project is available for distribution to project owners. Limited distribution projects, however, must limit distributions to project owners to a specified percentage of the owner's initial equity investment. Nonprofit owners may not be paid distributions of surplus cash. Such projects must deposit surplus cash into a "residual receipts account" that can be used to fund operating deficits in future years.

The type of project owner (i.e., profit-motivated, limited distribution, or not-for-profit) can vary based on the particular HUD program. For example, although profit-motivated owners may participate in most HUD programs, some programs, such as HUD's capital advance programs for the elderly and the disabled, are restricted to nonprofit owners. Other programs are predominantly available to limited distribution owners, i.e., profit-motivated owners who agree to restrict their surplus cash distributions in exchange for HUD subsidies. On the other hand, many HUD programs allow all three types of owners.

Project versus *Entity* Expenses

For financial reporting purposes, HUD requires that *project expenses* be segregated from *entity expenses*. To aid in that segregation, HUD's chart of accounts has separate account numbers for project expenses and entity expenses. Project expenses are expenses incurred in connection with the operation of the project, i.e., reasonable and necessary to the operation of the project. Entity expenses (sometimes referred to as *mortgagor expenses* or *corporate expenses*) are expenses attributable solely to the entity, for example, officers' salaries, federal and state income taxes, and legal expenses attributable to the entity *per se* (as distinct from the project). Entity expenses can only be paid from mortgagor contributions or surplus cash.

Lenders

Private Sector Lenders. The Federal Housing Administration (FHA) insures loans originated by HUD-approved lenders such as banks, savings and loans, and mortgage companies to finance the purchase of single family and multifamily housing. The lenders are subject to periodic review by the Asset Management Branch. Unless they are exempt, lenders that are approved to participate in FHA insurance programs are required to obtain an audit in accordance with the HUD audit guide in order to recertify their eligibility to participate in the programs.

Governmental Lenders. The Federal Home Loan Mortgage Corporation (Freddie Mac) and Federal National Mortgage Association (Fannie Mae) purchase loans made by private sector lenders and resell them to investors. By giving lenders an outlet to sell such loans, these governmental lenders encourage more mortgage lending.

State Housing Agencies and Indian Housing Authorities

State housing agencies issue bonds to finance multifamily housing projects and act as contract administrators for Section 8 rent subsidy projects. As contract administrators, the state agencies perform certain administrative duties on behalf of HUD for a fee. Those duties include providing oversight of project owners and management agents to assure compliance with HUD requirements.

Indian housing authorities operate much like housing agencies except the Section 8 subsidies are directed toward owners of housing for members of federally-recognized Indian tribes. Like housing agencies, Indian housing authorities serve as contract administrators and provide oversight of project owners to assure compliance with HUD requirements.

State housing agencies and Indian housing authorities may have their own audit and accounting guidelines, and those guidelines may differ from the HUD audit guide's requirements. In such cases, the auditors need to advise their client of the inconsistencies and meet with HUD and the housing agency or Indian housing authority to determine filing requirements that are acceptable to all concerned.

Management Agents

HUD projects may be managed by the project's owner, an outside management agent, or, for certain types of projects, a project administrator employed by the project. The project owner is responsible for seeking out and selecting someone to manage the project; however, the decision to self-manage a project or the selection of a management agent must be approved by HUD. Although outside the scope of this course, *PPC's Guide to HUD*

Audits discusses the Management Entity Profile and the Management Certification that project owners must file with the HUD field office to obtain approval of a management agent.

Management agents provide a variety of services to HUD projects, including marketing the rental units, bookkeeping, building maintenance, and landscaping. Whether the management fee is subject to review by HUD is based on the particular type of project.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. The HUD multifamily risk-sharing program is designed to do which of the following?
   a. To encourage the production of affordable rental housing.
   b. To facilitate the processing of mortgage applications efficiently.
   c. To construct, acquire, or rehabilitate housing for the elderly or disabled.
   d. To provide temporary funding to replenish project reserves.
2. Which category of the HUD's multifamily housing programs provides financial assistance to low-income tenants through payments that reduce the amount those tenants pay to the project owner?
   a. Capital advance programs.
   b. Section 202 direct loans.
   c. Rent subsidy programs.
   d. Insured loan programs.
3. Which HUD department has the responsibility for promoting integrity, effectiveness, and efficiency within the HUD programs?
   a. The Office of Financial Services.
   b. The Office of Housing Assistance and Grant Administration.
   c. The Real Estate Assessment Center.
   d. The Office of the Inspector General.
4. To assist in administering HUD programs across the country, which of the following has the authority for the oversight of day-to-day HUD projects?
   a. HUD headquarters.
   b. Department Enforcement Center.
   c. HUD field offices.
   d. Office of Recapitalization.

SELF STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. The HUD multifamily risk-sharing program is designed to do which of the following? **(Page 5)**

   a. **To encourage the production of affordable rental housing. [This answer is correct. The multifamily risk-sharing program is designed to encourage the production of affordable rental housing by allowing HUD to provide risk-sharing arrangements to state and local housing finance agencies.]**

   b. To facilitate the processing of mortgage applications efficiently. [This answer is incorrect. The objective of the coinsurance programs (not risk-sharing programs) was to facilitate the efficient processing of mortgage applications. Although coinsured mortgages are no longer made, HUD continues to service coinsured mortgages underwritten prior to November 12, 1990.]

   c. To construct, acquire, or rehabilitate housing for the elderly or disabled. [This answer is incorrect. HUD makes capital advances to nonprofit organizations for the construction, acquisition, or rehabilitation of housing for persons age 62 or older or disabled persons. Risk-sharing programs have a different purpose.]

   d. To provide temporary funding to replenish project reserves. [This answer is incorrect. Two types of loans are available under HUD's flexible subsidy (not risk-sharing) program—operating assistance loans and capital improvements loans. Both types of loans are generally made to projects with mortgages that are either insured or held by HUD. They are designed to provide temporary funding to replenish project reserves, cover operating costs, and pay for limited physical improvements. However, risk-sharing programs have a different function.]

2. Which category of the HUD's multifamily housing programs provides financial assistance to low-income tenants through payments that reduce the amount those tenants pay to the project owner? **(Page 6)**

   a. Capital advance programs. [This answer is incorrect. Only nonprofit projects are eligible for assistance under HUD's capital advance programs, which make capital advances for the construction, acquisition, or rehabilitation of housing for certain groups of individuals. This is a different purpose than the one described in this question.]

   b. Section 202 direct loans. [This answer is incorrect. Under Section 202 of the National Housing Act of 1959, HUD was authorized to make long-term loans directly to multifamily housing projects. Loan proceeds were used to finance the construction of housing for certain groups of individuals. Since this program was designed with a different purpose than that requested in this question, another answer is required.]

   c. **Rent subsidy programs. [This answer is correct. HUD rent subsidy programs provide financial assistance to low-income tenants of multifamily housing projects through payments that reduce the rent they pay. Under the programs, eligible tenants are only required to pay a portion of the market or HUD-approved rent, and HUD pays the difference on behalf of the tenants to the project owners.]**

   d. Insured loan programs. [This answer is incorrect. HUD administers several mortgage insurance programs that provide insurance to lenders to encourage them to make loans to developers and builders who construct or rehabilitate multifamily housing projects. Depending on the particular program, loan proceeds may be used to finance the construction of new housing or acquire or rehabilitate existing housing. However, this is a separate program than the one described in this question.]

3. Which HUD department has the responsibility for promoting integrity, effectiveness, and efficiency within the HUD programs? **(Page 6)**

   a. The Office of Financial Services. [This answer is incorrect. The Office of Financial Services maintains loan ledgers, escrow accounts, and reserve funds for mortgages of HUD projects that are held by HUD. Since, this office performs a separate function from the one described above, a different answer is required.]

   b. The Office of Housing Assistance and Grant Administration. [This answer is incorrect. The Office of Housing Assistance and Grant Administration administers the direct loan and capital advance programs for the elderly and disabled. Its function is different than that described above, so another answer is needed.]

   c. The Real Estate Assessment Center. [This answer is incorrect. HUD created its Real Estate Assessment Center (REAC) to centralize the assessment of all HUD housing. Its mission is to improve housing quality and assure the public trust by providing accurate, credible, and reliable assessments of HUD's real estate portfolio. The department requested in this question has a broader purpose.]

   d. **The Office of the Inspector General. [This answer is correct. The HUD Office of the Inspector General (OIG) is responsible for promoting the integrity, efficiency, and effectiveness of HUD programs. It works to accomplish this by conducting audits and investigating charges of fraud, waste, and abuse in HUD programs.]**

4. To assist in administering HUD programs across the country, which of the following has the authority for the oversight of day-to-day HUD projects? **(Page 7)**

   a. HUD headquarters. [This answer is incorrect. The Department of Housing and Urban Development—HUD headquarters—in Washington, D.C., administers all HUD programs nationwide. Much of the activity at HUD headquarters relates to HUD's administrative and legislative functions. However, day-to-day oversight of HUD projects is handled in a different manner.]

   b. Department Enforcement Center. [This answer is incorrect. HUD created the Departmental Enforcement Center (DEC) to take action against HUD-assisted entities that are responsible for waste, fraud, and abuse in HUD programs. The center receives referrals from the REAC of entities failing their financial or physical inspections. This office, however, is not responsible for overseeing day-to-day HUD projects.]

   c. **HUD field offices. [This answer is correct. To administer HUD programs throughout the country, HUD has established state offices and area offices. These field offices have authority for the day-to-day oversight of HUD projects and for interpreting HUD requirements. Within each field office, the Asset Management Branch and the Mortgage Credit Branch are of particular importance. The Asset Management Branch controls releases from project reserve funds, conducts physical inspections of HUD projects, and reviews project accounting procedures and leasing practices. The Mortgage Credit Branch is responsible for reviewing "cost certifications" submitted by developers of HUD projects.]**

   d. Office of Recapitalization. [This answer is incorrect. The Office of Recapitalization was created in 2014 to absorb the Office of Affordable Housing Preservation, the administrator of the Mark-to-Market program (M2M) after the legislative sunset of the Office of Multifamily Housing Assistance Restructuring. The M2M program was created to reduce the rents on expiring housing subsidy contracts to market levels and restructure existing debt to amounts that can be supported by these rents. In addition, the Office of Recapitalization oversees the Rental Assistance Demonstration Program and the Section 236 Preservation Program. However, day-to-day oversight of HUD programs is not the responsibility of this department.]

GUIDANCE APPLICABLE IN AUDITS OF HUD-ASSISTED ENTITIES

General Literature

GAAS and GAAP. Generally accepted accounting principles that apply to business entities and nonprofit organizations are equally applicable to for-profit or nonprofit entities that own or sponsor HUD programs. Similarly, all of the Statements on Auditing Standards (SASs) and Auditing Interpretations generally applicable to audits of financial statements may apply in HUD engagements. The authoritative auditing standards are discussed as applicable.

Generally Accepted Auditing Standards

Form and Structure of the Auditing Standards. Each auditing standard is divided into the following topics:

- **Introduction.** Includes matters such as the purpose and scope of the guidance, subject matter, effective date, and other introductory material.
- **Objectives.** Establishes objectives that allow the auditor to understand what to achieve under the standards. The auditor uses objectives to determine whether additional procedures are necessary for their achievement and evaluate whether sufficient appropriate audit evidence has been obtained.
- **Definitions.** Provides key definitions that are relevant to the standard.
- **Requirements.** States the requirements that the auditor is to follow to achieve the objectives unless the standard is not relevant or the requirement is conditional and the condition does not exist.
- **Application and Other Explanatory Material.** Provides further guidance to the auditor in applying or understanding the requirements. While this material does not in itself impose a requirement, auditors should understand this guidance. How it is applied will depend on professional judgment in the circumstances considering the objectives of the standard. The requirements section references the applicable application and explanatory material. Also, when appropriate, considerations relating to smaller and less complex entities are included in this section.

A standard may also contain exhibits or appendices. Appendices to a standard are part of the application and other explanatory material. The purpose and intended use of an appendix is explained in the standard or in the title and introduction of the appendix. Exhibits to standards are interpretive publications. Interpretive publications are not auditing standards and do not contain requirements. Rather, they are recommendations on applying the standards in particular circumstances that are issued under the authority of the Auditing Standards Board. Auditors are required to consider applicable interpretive publications when planning and performing the audit.

AU-C Section Organization. Within the AICPA Professional Standards, the auditing standards use "AU-C" section numbers. The organization of the AU-C sections is as follows:

- Preface.
- Glossary.
- AU-C Section 200–299, *General Principles and Responsibilities*.
- AU-C Section 300–499, *Risk Assessment and Response to Assessed Risks*.
- AU-C Section 500–599, *Audit Evidence*.
- AU-C Section 600–699, *Using the Work of Others*.
- AU-C Section 700–799, *Audit Conclusions and Reporting*.
- AU-C Section 800–899, *Special Considerations*.
- AU-C Section 900–999, *Special Considerations in the United States*.
- Appendixes.

When a new auditing standard is issued, the AICPA Professional Standards include the new and the preceding standard.

Changes to AU-C References. With the continued issuance of new auditing standards and the deferral of effective dates for other auditing standards, the AICPA made some unprecedented changes in how it organizes the SASs. The three "series" of AU-C references are as follows:

- AU-C XXX, the *core* series. The core or primary AU-C Section number with no alpha character after the number will be updated to include the latest SAS issued, regardless of its effective date, and will reflect the most recent literature. The core series contains all the auditing standards issued to date (through SAS No. 148 at the time this course was updated).

- AU-C XXXB series. The B series includes the auditing standards that apply before SAS No. 134, *Auditor Reporting and Amendments, Including Amendments Addressing Disclosures in the Audit of Financial Statements*, is implemented and is a complete codification containing all AU-C standards before implementation of SAS No. 134. Each section is designated with a "B" suffix (AU-C XXXB, such as AU-C 700B). This section is intended to assist auditors and firms that are not implementing SAS Nos. 134–140 prior to the delayed effective date as a result of the issuance of SAS No. 141. Upon implementation of SAS Nos. 134–140, the AU-C XXXB series should not be used. Given that after the delay, SAS No. 134–140 were effective for audits of periods ending on or after December 15, 2021, this edition of the course fully incorporates SAS Nos. 134–140 and as such does not refer to the AU-C XXXB series.

- AU-C XXXA series. The A series includes the auditing standards that apply *after* implementation of SAS No. 134 and the related reporting standards (that is, the standards up through SAS No. 141), but *before* implementation of SAS No. 142 or any subsequent SASs. Note that this is not a complete set of professional standards, but simply a bridge between the AU-C XXXB series and the AU-C XXX core series. At the time this course was updated, the AU-C XXXA series includes: AU-C 210A, *Terms of Engagement*; AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*; AU-C 315A, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; AU-C 500A, *Audit Evidence*, the related interpretation at AU-C 9500A, AU-C 501A, *Audit Evidence—Specific Considerations for Selected Items*, and AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*. Amendments to other AU-C sections by those recently issued ASUs are not fully integrated into the core AU-C sections. Instead, there is a Note at the beginning of each affected core AU-C section referring the user to the appropriate appendix to for the related amendments. Based on the relevant effective dates of SAS No. 142 and the subsequently issued SASs, this edition of the course fully incorporates SAS No. 142, but does not fully incorporate SAS No. 143–147. As a result, this course uses AU-C 500 references to represent the implementation of SAS No. 142, *Audit Evidence*, but generally uses the applicable AU-C XXXA references for the other sections included in the AU-C XXXA series.

Recent Auditing Standards Issued. Recent and proposed standards from the Auditing Standards Board of the AICPA are discussed in the following paragraphs.

<u>SAS No. 142, *Audit Evidence*.</u> In July 2020, the AICPA issued SAS No. 142, *Audit Evidence*. SAS No. 142, which is now codified at AU-C 500 supersedes current guidance now codified at AU-C 500A, moves guidance on the use of management specialists to AU-C 501, and amends various other AU-C sections. Key areas of change or potential improvement in audit quality covered by SAS No. 142 and amendments include use of automated tools and techniques, corroborative and contradictory information, conscious and unconscious bias, use of external information sources and the nuances of reliability of information as audit evidence. SAS No. 142 is effective for audits of financial statements for periods ending on or after December 15, 2022. Based upon the effective date, this edition of the course fully incorporates SAS No. 142.

<u>SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*.</u> In July 2020, the AICPA issued SAS No. 143, *Auditing Accounting Estimates and Related Disclosures*. SAS No. 143 addresses the auditor's responsibilities relating to accounting estimates, including fair value accounting estimates, and related disclosures in an audit of financial statements. The standard retains the familiar requirement that the auditor's further procedures should include one or more of three approaches: (a) obtain evidence from events occurring up to the audit report date, (b)

test how management made the estimate, or (c) develop the auditor's own point estimate or range, and adds new requirements and guidance regarding assessment of risk of material misstatement, audit documentation, and communications to those charged with governance related to accounting estimates. SAS No. 143, which is now codified at AU-C 540, supersedes *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, which is now codified at AU-C 540A, and amends various other AU-C sections. SAS No. 143 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 143.

SAS No. 144, *Amendments to AU-C Sections 501, 540 and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. In June 2021, the AICPA issued SAS No. 144, *Amendments to AU-C Sections 501, 540 and 620 Related to the Use of Specialists and the Use of Pricing Information Obtained From External Information Sources*. The SAS provides enhanced guidance on (1) evaluating the work of management's specialist with regard to developing accounting estimates; (2) the use of information from third-party pricing services when evaluating estimates of fair value of financial instruments; and (3) using the work of an auditor's specialist. SAS No. 144 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based upon the effective date, this edition of the course does not fully incorporate SAS No. 144.

SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. In October 2021, the ASB issued SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The SAS supersedes AU-C 315A and amend other auditing standards related to risk assessment. Key aspects of SAS No. 145 include requirements or clarifications related to assessment of the risks of material misstatement at the assertion level and requirements related to understanding and evaluating the entity's system of internal control. SAS No. 145 is effective for audits of financial statements for periods ending on or after December 15, 2023. Based on the effective date, this edition of the course does not fully incorporate SAS No. 145. SAS No. 145 is not intended to fundamentally change the manner in which the audit is performed, but rather clarifies and enhances key elements and definitions of the risk assessment process. The ultimate aim of SAS No. 145 is to equip the auditor to perform better risk assessments, and as a result, enhance audit quality. The following paragraphs provide further detail on some of the most significant aspects of SAS No. 145. Note that this summary does not discuss all of the changes to the auditing standards.

SAS No. 145 (AU-C 315.12) introduces or revises several key definitions and concepts that are the building blocks for assessing risk:

- *Relevant assertions.* "An assertion about a class of transactions, account balance, or disclosure is relevant when it has an identified risk of material misstatement based on inherent risk." Risk of material misstatement exists when there is a reasonable possibility of a misstatement occurring (i.e. its likelihood), *and*, if it were to occur, there is a reasonable possibility of the misstatement being material (i.e. its magnitude).

- *Inherent risk factors.* "Characteristics of events or conditions that affect the susceptibility to misstatement, whether due to fraud or error, of an assertion about a class of transactions, account balance, or disclosure, before consideration of controls."

- *Spectrum of inherent risk.* The scale of the degree to which inherent risk factors affect the susceptibility of an assertion to misstatement. The intersection of the magnitude and likelihood of the material misstatement on the spectrum of inherent risk will determine whether the assessed inherent risk is higher or lower on the spectrum of inherent risk.

- *Significant class of transactions, account balance, or disclosure.* "A class of transaction, account balance, or disclosure for which there is one or more relevant assertions."

- *Significant risk.* An identified risk of material misstatement for which the assessment of inherent risk is close to the upper end of the spectrum of inherent risk due to the degree to which inherent risk factors affect the combination of the likelihood and magnitude of a potential misstatement. Significant risks may also include identified risks of material misstatements required to be treated as a significant risk in accordance with AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, or AU-C 550, *Related Parties*.

Both AU-C 315 and AU-C 315A require auditors to identify and assess the risks of material misstatement at both the financial statement level and at the assertion level. Under SAS No. 145 (AU-C 315), the auditor is required to assess risk of material misstatements for significant classes of transactions, account balances, or disclosures. The authors believe this will require a more granular assessment than previous requirements. Depending on the engagement, this may lead to the identification of additional audit areas. SAS No. 145 clarifies and enhances the risk identification and assessment process, through the key changes discussed below.

For risks of material misstatement at the assertion level, SAS No. 145 requires separate assessments of inherent risk and control risk (as opposed to the currently existing option to solely assess risk of material misstatement at the assertion level, with no individual assessment of inherent risk or control risk).

In regards to the separate assessment of control risk, if the auditor does not plan to test the operating effectiveness of controls, SAS No. 145 requires the auditor to assess control risk at the maximum level such that the assessment of the risk of material misstatement is the same as the assessment of inherent risk. Tests of the operating effectiveness of controls are continued to be required to support a control risk assessment below the maximum level.

SAS No. 145 also revises requirements related to the understanding of the entity's system of internal control, assessing control risk, and evaluating the design and implementation of certain controls, including general IT controls. There are certain terminology changes introduced in SAS No. 145, including the use of the term *system of internal control* to replace the term *internal control* when describing the five interrelated components. The auditor is not required to obtain an understanding of all of the processes or controls within each of the five components, which are (a) control environment, (b) the entity's risk assessment process, (c) the entity's process to monitor the system of internal control, (d) the information system and communication, and (e) control activities. For components a to c (control environment, risk assessment process and monitoring) the understanding is directed to the aspects of components relevant to the preparation of financial statements and what is required to achieve the entity's financial reporting objectives. AU-C 315 does not require the auditor to evaluate the design or determine the implementation of individual controls within these three components. Even for component d (information system and communication), the auditor is not required to identify all information-processing controls or evaluate the design or determine the implementation of individual controls within the component. The auditor's focus is on understanding the flow of transactions and related aspects of information-processing activities. For component e (control activities), the auditor's focus is on identifying certain information-processing controls that address risks of material misstatement at the assertion level. Information-processing controls may have previously been referred to as transaction controls.

The evaluation of the control's appropriate design and implementation is only required for specifically identified controls. Identified controls may have previously been referred to as key controls or relevant controls. Such controls include those which:

- address a risk that is determined to be a significant risk
- control journal entries and other adjustments as required by AU-C 240
- will be tested for operating effectiveness
- address risks for which substantive procedures alone do not provide sufficient appropriate audit evidence
- meet the objectives of identifying risks of material misstatement at the assertion level and designing further audit procedures based on the auditor's professional judgment

SAS No. 145 includes a new stand-back requirement that is intended to drive the auditor to evaluate the completeness of the identification of significant classes of transactions, account balances, and disclosures. In a conforming amendment to AU-C 330*, Performing Audit Procedures in Response to Assessed Risks*, SAS No. 145 requires the auditor to perform substantive procedures for each relevant assertion of each *significant* class of transactions, account balance, and disclosure, regardless of the assessed level of control risk. This conforming amendment replaces the current requirement to perform substantive procedures for all relevant assertions related to each *material* class of transactions, account balance, and disclosure, irrespective of the assessed risks of material misstatement. As such, the stand-back requirement is intended for auditors to sufficiently challenge any situations wherein a material class of transactions, account balance, or disclosure was not identified as significant.

As stated earlier, this course does not fully incorporate the requirements of SAS No. 145. If performing an audit after the implementation of SAS No. 145, consider any changes necessary to comply with the requirements of SAS No.

145 and tailor the audit accordingly. The 2023 edition of this course will fully incorporate SAS Nos. 143, 144, and 145.

SAS No. 146, *Quality Management for an Engagement Conducted in Accordance with Generally Accepted Auditing Standards*. In June 2022, the ASB issued SAS No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, as well as Quality Management Standard No. 1, *A Firm's System of Quality Management* (SQMS No. 1), and Quality Management Standard No. 2, *Engagement Quality Reviews* (SQMS No. 2), as part of its quality management standards project. SAS No. 146 supersedes AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, and amends various other AU-C sections. SQMS No. 1 supersedes SQCS No. 8, and SQMS No. 2 provides requirements for the appointment and eligibility of engagement quality reviewers and performance of engagement quality reviews. SAS No. 146 is effective for engagements conducted in accordance with GAAS for periods beginning on or after December 15, 2025. The quality management standards in SQMS No. 1 are required to be designed and implemented by December 15, 2025, with an evaluation of the system of quality management to be performed within one year. SQMS No. 2 is effective for audits and reviews of financial statements for periods beginning on or after December 15, 2025, and for other engagements in a firm's accounting and auditing practice beginning on or after December 15, 2025. Future editions of this course will incorporate the new requirements as the effective date nears.

SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations*. In June 2022, the ASB issued SAS No. 147, *Inquiries of the Predecessor Auditor Regarding Fraud and Noncompliance with Laws and Regulations*, which amends SAS No. 122, AU-C 210A, *Terms of Engagement*. SAS No. 147 is designed to further the public interest by enhancing communication between predecessor and successor auditors. SAS No. 147 requires the successor auditor to ask the predecessor auditor about identified or suspected fraud or noncompliance with laws and regulations if management has authorized the predecessor auditor to respond. A refusal to consent by the client would be a significant red flag that the auditor would consider in determining whether to accept the engagement. Under unusual circumstances, a predecessor auditor may decide not to fully respond to the auditor's inquires; however, the predecessor auditor should clearly state their response is limited. SAS No. 147 is effective for audits of financial statements for periods beginning on or after June 30, 2023, with early implementation permitted. Future editions of this course will incorporate the new requirements as the effective date nears.

SAS No. 148, *Amendment to AU-C Section 935*. In August 2022, the ASB issued SAS No. 148, *Amendment to AU-C Section 935*. AU-C 935, *Compliance Audits*, applies when an auditor is engaged, or legally required to perform a compliance audit, and addresses the application of generally accepted auditing standards to the compliance audit. SAS No. 148 is intended to make changes to AU-C 935 to update the appendix with regard to AU-C 501 and to conform the standard for the issuance of SAS No. 142, *Audit Evidence*, and SAS No. 145, *Understanding the Entity and its Environment and Assessing the Risks for Material Misstatement*. The amendment to the appendix related to AU-C 501, *Audit Evidence—Specific Considerations for Selected Items*, is due to paragraph .08 of AU-C section 500A moving to paragraph .27 of AU-C section 501 with the implementation of SAS No. 142. There were no substantive changes to the requirements in that paragraph. Therefore, this amendment to AU-C 935 does not change current practice and becomes effective for compliance audits for fiscal periods ending on or after December 15, 2022, in order to align with the effective date of SAS No. 142. This edition of the course fully incorporates SAS No. 142.

The amendments to AU-C 935 resulting from the issuance of SAS No. 145 include the following:

- The appendix to AU-C 935, "AU-C Sections That Are Not Applicable to Compliance Audits," was updated for certain paragraphs in AU-C sections 315 and 330 that are modified with the implementation of SAS No. 145.
- A new requirement was added to address the auditor's responsibility in addressing provisions of SAS No. 145 regarding certain controls that the auditor is required to identify, which include controls over compliance that are required to be tested for operating effectiveness.
- New requirements related to assessing inherent risk and control risk for identified risks of material noncompliance were added.

- New requirements surrounding control activities related to the risks arising from the use of IT were added.
- Miscellaneous other changes were made for clarity and consistency.

The amendments resulting from the issuance of SAS No. 145 are effective for compliance audits for fiscal periods ending on or after December 15, 2023, consistent with the effective date of SAS No. 145. Due to the delayed effective date, this edition of the course does not fully incorporate SAS No. 145. Early implementation of SAS No. 148 is permitted, however, the implementation should be in conjunction with SAS Nos. 142 or 145, as applicable, for compliance audits performed under AU-C 935.

ASB's Quality Management Standards. In June 2022, the Auditing Standards Board issued the following three interrelated standards:

- Statement on Quality Management Standards No. 1, *A Firm's System of Quality Management* (SQMS No. 1).
- Statement on Quality Management Standards No. 2, *Engagement Quality Reviews* (SQMS No. 2).
- Statement on Auditing Standards (SAS) No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (SAS No. 146).

SQMS No. 1 supersedes SQCS No. 8, SQMS No. 2 provides the requirements for the appointment and eligibility of engagement quality reviewers and performance of engagement quality reviews, and SAS No. 146 supersedes AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*. Various other AU-C sections are also amended by the guidance. The ASB believes the quality management standards improve the scalability of the standards and promote a quality management system that is more tailored to the firm and its engagements. Firms are required to design and implement systems of quality management in compliance with SQMS No. 1 by December 15, 2025, and to perform an evaluation of the system of quality management required by SQMS No. 1 within one year following December 15, 2025. SQMS No. 2 is effective for audits or reviews of financial statements for periods beginning on or after December 15, 2025. SQMS No. 2 is effective for the firm's other engagements in its accounting and auditing practice beginning on or after December 15, 2025. Some of the key changes of SQMS Nos. 1 and 2 are further discussed below.

SQMS No. 1 takes a new approach in addressing the firm's responsibility to design, implement, and operate a system of quality management for its accounting and auditing practice. The new approach is risk-based and designed to improve scalability of the standards by requiring a quality management system that is tailored to the nature and circumstances of the firm and its engagements. The new approach requires a firm to customize its system of quality management based on the nature and circumstances of the firm and its engagements, using an approach that considers the quality management system as a whole, with a stronger focus on continual remediation and improvement. Under SQMS No. 1, the firm's system of quality management is comprised of eight components rather than the six quality control elements under SQCS No. 8. SQMS No. 1 adapts the existing six QC elements, renaming three of them, and adds two new components. An eligible engagement quality control reviewer is not a member of the engagement team; thus the review allows for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon.

SQMS No. 2 deals with the appointment and eligibility of the engagement quality reviewer, and the requirements, performance, and documentation of the engagement quality review. The appointment and eligibility of the engagement quality reviewer requirements are more robust than under current SQCS No. 8.

Proposed SAS, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*. In March 2022, the ASB issued an exposure draft of a proposed SAS, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors and Audits of Referred-to Auditors)*. The proposed SAS would supersede extant guidance in AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, and amend other AU-C sections to conform to the group audits standard. The proposed SAS is part of the ASB's strategy to converge its standards with those of the International Auditing and Assurance Standards Board (IAASB), while taking into consideration other standard-setters. The objective of the proposed SAS is to strengthen the auditor's approach to planning and performing a group audit, as well as to improve the overall quality of group audits, by introducing a principles-based approach focused on identifying, assessing, and responding to the risk of material misstatement. This approach clarifies that all AU-C sections need to be applied in a group audit by establishing stronger linkages to the other AU-C sections, namely AU-C 315, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*; AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*; and SAS No. 146. The proposed SAS also clarifies the scope and applicability of the standard by revising the definition of group financial statements. Among other things, the definition specifically includes the financial information of entities or business units (such as branches or divisions) if they are aggregated through a consolidation process. The proposed SAS retains extant guidance allowing the group engagement partner to make reference to another auditor in the auditor's report on group financial statements. Accordingly, the proposed SAS revises the definition of a component auditor and introduces the term *referred-to auditor*. The *referred-to auditor* is not a component auditor and is not part of the engagement team in a group audit. The tentative effective date, as proposed, would be for audits of financial statements for periods ending on or after December 15, 2026. Future editions of the course will be updated for any new developments. Readers can follow this project at **www.aicpa.org**.

AICPA *Code of Professional Conduct*

The AICPA *Code of Professional Conduct* provides guidance and rules that auditors need to comply with in connection with an audit engagement. As noted in AU-C 220A.A4, it sets forth the fundamental principles of professional ethics, including objectivity and independence.

AU-C 200.15 states the auditor is required to be independent when performing an audit in accordance with GAAS. AU-C 200.16 also requires auditors to follow ethical requirements that are relevant to the engagement.

Government Auditing Standards

Audits of HUD programs are conducted in accordance with generally accepted government auditing standards (GAGAS) as specified in the Government Accountability Office's (GAO), *Government Auditing Standards*, often referred to as the "Yellow Book." The Yellow Book standards relate to scope and quality of audit efforts and to the characteristics of a professional and meaningful audit report. As stated in Paragraph 1.06 of the *Government Auditing Standards, 2018 Revision Technical Update April 2021* (Yellow Book), GAGAS "provide a framework for conducting high-quality engagements with competence, integrity, objectivity, and independence." They address the concerns of public officials, legislators, and the general public about whether governmental funds are handled properly and in compliance with existing laws and whether governmental programs are being conducted efficiently, effectively, and economically.

GAGAS recognize that the AICPA has adopted standards and procedures applicable to audits performed to express opinions on whether financial statements fairly present the financial position and results of operations. For financial audits, the Yellow Book incorporates the AICPA's field work and reporting standards and the related SASs, unless they are specifically excluded or modified. However, *Government Auditing Standards* fulfill broader interests and are identified as standards for "broad scope" auditing. The standards identify the ethical principles that are the foundation of governmental audits and establish requirements for the scope of audit work, auditor qualifications and independence, competence of the audit staff, exercise of professional judgment, and quality control and external peer reviews, as well as standards for planning, supervision, and reporting.

GAGAS has no authority on its own. In other words, the GAO provides government auditing standards in the Yellow Book, but has no authority to require compliance with them. As stated in Paragraph 1.08 of the Yellow Book:

> Laws, regulations, contracts, grant agreements, and policies frequently require that engagements be conducted in accordance with GAGAS. The requirements and guidance in GAGAS in totality apply to engagements pertaining to government entities, programs, activities, and functions, and to government assistance administered by contractors, nonprofit entities, and other nongovernmental entities when the use of GAGAS is required or is voluntarily adopted.

In audits of HUD programs, compliance with the Yellow Book is required by HUD's *Consolidated Audit Guide for Audits of HUD Programs* for for-profit entities, and the Single Audit Act for nonprofit entities. The Yellow Book is available in *PPC's Government Documents Library* at Gov. Doc. No. 2.

Government Auditing Standards, 2018 Revision Technical Update April 2021. In July 2018, the GAO issued *Government Auditing Standards, 2018 Revision* (Yellow Book). In April 2021, the GAO issued limited technical updates to the Yellow Book, which were effective upon issuance. The changes are considered minor and have been incorporated in this course. One technical update of note is in Paragraph 3.83 of the Yellow Book, which discusses the auditor's evaluation of nonaudit services and their effect on independence. This paragraph now states that auditors should "determine whether the skill, knowledge, or experience of the individual responsible for overseeing the nonaudit service was sufficient…." The previous version used the term *and* rather than *or*. The other updates include the introduction of the term equitable as it relates to governments' responsibilities in providing public services and the addition of clarifying language to the discussion of internal controls in performance audits. References to the "Yellow Book" throughout this course include the April 2021 technical updates.

Standards and guidance applicable to financial audits conducted in accordance with GAGAS are contained in chapters 1 through 6 of the Yellow Book. These chapters include ethical principles, general requirements for complying with GAGAS, and additional standards for performing and reporting on financial audits.

Chapter 1—Foundation and Principles for the Use and Application of *Government Auditing Standards*. Chapter 1 includes the introduction and the foundation and principles of government auditing. The chapter discusses the types of auditors and audit organizations that may employ GAGAS to conduct their work, the types of engagements that may be conducted in accordance with GAGAS, and defines common terms used throughout the Yellow Book.

Chapter 2—General Requirements for Complying with *Government Auditing Standards*. Chapter 2 provides an overall discussion on the general requirements for complying with and applying *Government Auditing Standards*. It discusses unconditional and presumptively mandatory requirements and the relationship between GAGAS and other professional standards, such as audit, review, and attestation standards issued by the AICPA. It also provides requirements for stating compliance with GAGAS in the auditor's report. Among other things, it contains requirements for using other audit standards such as the AICPA auditing standards in conjunction with GAGAS and for reporting compliance with GAGAS in the audit report. The chapter also emphasizes the role of professional judgment in determining the appropriate type of statement to be used for stating compliance with *Government Auditing Standards* in the auditors' report.

Chapter 3—Ethics, Independence, and Professional Judgment. Chapter 3 presents the ethical principles and establishes the independence and professional judgment standards. The ethical principles do not establish specific standards or requirements; however, they provide the foundation, discipline, and structure that affect the application of *Government Auditing Standards*. The ethical principles relate to preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the standards cited in the auditor's report.

Chapter 3 includes four interrelated sections related to independence (i.e., general requirements, requirements and guidance for applying the conceptual framework, requirements and guidance for providing nonaudit services, and requirements and guidance on documentation to support auditor independence). In general, the auditor identifies and evaluates threats to independence and determines if safeguards can be put in place to mitigate significant threats. (Safeguards are controls that eliminate threats or reduce them to an acceptable level.) Certain specific nonaudit services are prohibited and others require designation as a significant threat.

Chapter 4—Competence and Continuing Professional Education. Chapter 4 contains the Yellow Book's competence standards and requirements for continuing education. The requirements include the assignment of auditors who possess competence for their assigned roles on the engagement as well as processes within the firm to recruit, hire, train, and evaluate personnel to ensure they have the essential skills, knowledge, and abilities required to conduct a GAGAS engagement. Auditors who plan, direct, perform procedures, or report on a GAGAS engagement must complete specific CPE as outlined in Chapter 4.

Chapter 5—Quality Control and Peer Review. Chapter 5 establishes requirements and guidance for quality control and reporting on peer reviews of organizations that conduct engagements in accordance with GAGAS. Entities that conduct Yellow Book audits are required to document a system of quality control, which should include policies and procedures on leadership responsibilities; independence, legal, and ethical requirements; engagement initiation, acceptance, and continuance; and human resources, engagement performance, and monitoring its system of quality control. Entities that perform Yellow Book audits are required to obtain an external peer review. Chapter 5 provides requirements for the peer review team and for the firm to make the peer review report available to the public.

Chapter 6—Standards for Financial Audits. Chapter 6 includes considerations for both performing and reporting on financial audits conducted in accordance with *Government Auditing Standards*. It incorporates, by reference, the AICPA's performance and reporting standards and the corresponding Statements on Auditing Standards. All sections of the SASs are incorporated, including the introduction, objectives, definitions, requirements, and application material. For financial audits conducted in accordance with GAGAS, the requirements and guidance in the incorporated SASs and Chapter 6 apply.

Certain AICPA standards that may have unique considerations in the government environment, include the following:

- *Materiality.* It may be appropriate to use a lower materiality level in Yellow Book audits than in non-Yellow Book audits due to (a) the public accountability of government entities and entities receiving government funding, (b) various legal and regulatory requirements, and (c) the visibility and sensitivity of government programs.

- *Early Communication of Control Deficiencies.* Early communication is important for some internal control deficiencies because of the significance and urgency for corrective action. When a deficiency is communicated early, it still must be included in the report on internal control and compliance the auditor issues at the end of the audit.

Yellow Book reporting requirements that extend beyond that of the AICPA relate to:

- Reporting the auditors' compliance with *Government Auditing Standards*.

- Reporting on internal control; compliance with provisions of laws, regulations, contracts, and grant agreements; and instances of fraud.

- Presenting findings in the audit report and directly to parties outside the audited entity.

- Obtaining and reporting views of responsible officials.

- Reporting confidential or sensitive information.

- Distributing reports.

Yellow Book requirements for performing a financial audit that extend beyond those of the AICPA include requirements relating to:

- Licensing and certification.

- Auditor communication.

- Results of previous engagements.

- Investigations or legal proceedings.

- Noncompliance with provisions of laws, regulations, contracts, and grant agreements.

- Developing elements of a finding.

- Audit documentation.

- Availability of individuals and documentation.

The requirements and guidance contained in Chapters 1 through 6 of the Yellow Book are discussed throughout this course, as applicable.

HUD Literature

HUD Audit Guide, Applicable for For-profit Audits. In addition to GAAS and GAGAS, audits of for-profit HUD-assisted entities also must comply with the HUD audit guide issued by the HUD Office of Inspector General. The most current *Consolidated Audit Guide for Audits of HUD Programs* (HUD Handbook 2000.04 REV-2), was originally issued in December 2001. Since the time the handbook was issued in its entirety in 2001, the HUD OIG has incorporated changes in the professional standards and regulatory environment by periodically issuing updates of individual chapters, known as changes. As of the date this course was completed, the HUD OIG had revised and released all seven of the audit guide chapters at least once. Previously, HUD OIG stated that when all of the individual chapters of the HUD audit guide were revised, they would be consolidated into a revised audit guide and issued as HUD Handbook 2000.04 REV-3. However, HUD OIG has not announced the timing for issuance of a new consolidated audit guide.

The HUD audit guide, among other things, requires auditors to perform sufficient audit procedures to issue an opinion as to whether the HUD-assisted entity complied with laws, regulations and the provisions of contracts or grant agreements that could have a direct and material effect on the entity's major HUD programs. Highlights of the HUD audit guide include the following:

a. *Audit Scope and Approach.* The HUD audit guide establishes the criteria for determining whether assistance under a HUD program is considered to be a major program and, thus, requires a compliance audit. When a compliance audit is required, the HUD-assisted entity must also obtain an audit of its financial statements.

b. *Procedures for Testing the Entity's Compliance with Laws and Regulations Affecting Major HUD-assisted Programs.* The HUD audit guide includes suggested audit procedures for testing specific compliance requirements applicable to major HUD programs.

c. *Requirement to Test Internal Control over Compliance for Major HUD Programs.* The HUD audit guide states that auditors should perform tests of controls "to evaluate the effectiveness of the design and operation of internal controls in preventing or detecting material noncompliance with the direct and material requirements of the major HUD-assisted programs" [HUD audit guide, Paragraph 1-3(B)].

d. *Basic Financial Statements and Supplementary Information.* The HUD audit guide describes the supplementary information that must be presented with the basic financial statements. Generally, an entity's financial statements must be submitted to HUD within 90 days after the end of its fiscal year.

e. *Auditor's Reports.* The HUD audit guide discusses the auditor's reporting responsibilities and provides report examples.

f. *Auditor and Client-prepared Schedules.* The HUD audit guide specifies additional separate schedules that are to accompany the financial statements and auditor's reports. It describes the form and content of the schedule of findings, questioned costs, and recommendations that is prepared by the auditor; the schedule of the status of prior audit findings, questioned costs, and recommendations; and the corrective action plan that are prepared by management of the HUD entity.

As of the date of this course, the dates of the most recent issuances and the topics covered by each chapter of the HUD audit guide are effective as follows:

- *Chapter 1, "General Audit Guidance."* The most recent version of this chapter was issued in May 2013 and was effective for audits of fiscal years ending on or after June 30, 2013. Chapter 1 provides an overview of the purpose of the HUD audit guide and various audit performance, communication, and reporting requirements. Chapter 1 provides general guidance, establishes the audit scope and approach, and discusses the linkage to compliance requirements in Chapters 3 through 7 of the HUD audit guide. Because of its general nature, the guidance in Chapter 1 affects many aspects of HUD audits; it is discussed where applicable throughout this course.
- *Chapter 2, "Reporting Requirements and Sample Reports."* The most recent version of this chapter was issued in March 2013 and was effective for audits of fiscal years ending on or after March 31, 2013.

Chapter 2 provides general guidance for the reports and schedules that are issued in the compliance audit performed in accordance with Chapters 3 through 7 of the HUD audit guide.

- *Chapter 3, "HUD Multifamily Housing Programs."* The latest version of this chapter was issued in July 2008. Chapter 3 provides the compliance requirements and suggested audit procedures for testing the entity's compliance with requirements governing multifamily HUD programs. It also requires auditors to test controls to evaluate the effectiveness of the design and operation of internal control in preventing or detecting material noncompliance with the requirements of HUD programs.

- *Chapter 4, "Mortgage Insurance for Hospitals Program."* The latest version of this chapter was issued in September 2014. Chapter 4 provides interim audit guidance for the HUD multifamily hospital program while HUD revises the chapter in its entirety. This course does not provide guidance for audits of the HUD multifamily hospital program.

- *Chapter 5, "Development Cost Certification Audit Guidance."* The most recent version of this chapter was issued in March 2007. Limited guidance for cost certification audits is provided in *PPC's Guide to HUD Audits*.

- *Chapter 6, "Ginnie Mae Issuers of Mortgage-Backed Securities Audit Guidance."* This chapter provides guidance to auditors of lenders who participate in GNMA's mortgage-backed securities program. A revision of this chapter was issued in February 2016 and was effective upon issuance. This course does not discuss audits of lenders in this program.

- *Chapter 7, "FHA-Approved Lenders Audit Guidance."* The most recent version of this chapter was issued in June 2021 and was effective upon issuance. Limited guidance for audits of FHA-approved lenders is provided in *PPC's Guide to HUD Audits*.

HUD Handbook—*Financial Operations and Accounting Procedures for Insured Multifamily Projects*. HUD Handbook, *Financial Operations and Accounting Procedures for Insured Multifamily Projects* (HUD Handbook 4370.2 REV-1, CHG-1), provides accounting guidance for most HUD-insured multifamily projects. The handbook has not been updated to reflect changes in authoritative standards or the changes in the financial reporting standards documented on the REAC website. HUD has not provided a timeline for updating this handbook, therefore the authors recommend that auditors be alert for the issuance of a revised handbook. In the meantime, the authors believe that the information posted on the REAC website should be followed even if it conflicts with the HUD handbook.

Important notices about technology changes, submission procedures, accounting requirements, and other developments relating to multifamily housing projects are posted to REAC's webpage devoted to multifamily housing news at **www.hud.gov/program_offices/public_indian_housing/reac/products/prodmf#fass-audit**. Accountants and auditors can monitor this webpage for current information about electronic submission requirements and links to useful resources. In addition, the authors believe the following documents are especially helpful for project owners and auditors of multifamily programs. Links to the documents can be found at **www.hud.gov/program_offices/public_indian_housing/reac/library/lib_famf**.

- Industry User Guide for the Financial Assessment Subsystem-Multifamily Housing (December 7, 2018) (FASSUB User Guide).

- *Summary of Financial Reporting and Auditing Guidance for HUD Multifamily Program Participants and Independent Auditors* (February 2003).

- *Submission and Review Requirements and REMS Critical Data Fields for Annual Financial Statements* (June 2004).

- *Guidelines on Reporting and Attestation Requirements of Uniform Financial Reporting Standards (UFRS)* (March 2001).

While not setting new requirements or replacing existing requirements contained in the HUD handbooks, they do summarize many of the accounting, annual financial reporting, and auditing requirements of multifamily programs.

Other HUD Handbooks. HUD has issued a number of handbooks in addition to the HUD audit guide and the handbooks listed above. Exhibit 1-1 is a list of HUD handbooks applicable to HUD-assisted project owners.

Exhibit 1-1

HUD Handbooks
Applicable to HUD-assisted Project Owners
(as of September 2022)[a]

Handbook No.	Issue Date or Date of Latest Change	Title
Accounting and Auditing Handbooks:		
IG 2000.04 REV-2[b]	06/2021	*Consolidated Audit Guide for Audits of HUD Programs*
4370.1 REV-2	8/95	*Reviewing Annual and Monthly Financial Reports*
4370.2 REV-1	1/23/96	*Financial Operations and Accounting Procedures for Insured Multifamily Projects*
4370.3	6/30/92	*Uniform System of Accounts for Cooperative Housing Corporations Using Manual and Computer Accounting Systems*
4370.4 REV-1	6/24/92	*Basic Accounting Desk Reference for HUD Loan Servicers*
Other Handbooks:		
4350.1 REV-2	8/31/2012	*Multifamily Asset Management and Project Servicing*
4350.2 REV-1	8/20/93	*Section 8 Loan Management Set Aside Program for Projects with HUD-Insured and HUD-Held Mortgages*
4350.3 REV-1	11/27/2013	*Occupancy Requirements of Subsidized Multifamily Housing Programs*
4350.5	6/14/94	*Subsidy Contract Administration and Field Monitoring*
4350.6	8/7/95	*Processing Plans of Action Under the Low Income Housing Preservation and Resident Homeownership Act of 1990*
4355.1 REV-1	5/29/92	*Flexible Subsidy*
4381.5 REV-2	6/8/2006	*Management Agent Handbook*
4566.2	8/95	*Management, Servicing and Disposition Requirements for Projects with 223(f) Coinsured Loans*
4571.1 REV-2	3/83	*Section 202 Direct Loan Programs for Housing for the Elderly or Handicapped*
4571.2	6/3/91	*Section 811 Supportive Housing for Persons with Disabilities*
4571.3 REV-1	4/9/93	*Supportive Housing for the Elderly Section 202 Program*
4571.4	6/7/94	*Supportive Housing for Persons with Disabilities, Conditional Commitment—Final Closing*

Notes:

[a] HUD handbooks are all available online and can be viewed or downloaded from HUD's website. The web page at **www.hud.gov/resources** provides links to HUD handbooks, forms, and publications.

[b] The current status of the HUD OIG's program to update the HUD audit guide was discussed earlier in this section. A link to the HUD audit guide is available at **www.hudoig.gov/library/single-audit-guidance/hud-consolidated-audit-guide**.

HUD Internet Sites. Most of the information discussed in this section, as well as other HUD information and forms, can be obtained from various sites on the Internet.

Single Audit Act and OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*, Applicable for Nonprofit Audits

Nonprofit entities that participate in HUD programs are included in the scope of the amended Single Audit Act and OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) The provisions of the Uniform Guidance differ from those in the HUD audit guide in the following primary areas:

- Audit threshold.
- Major program determination.
- Source of compliance requirements.
- Form of reporting audit findings and threshold for determination of questioned costs.
- Requirement to submit the schedule of expenditures of federal awards.
- Requirements when sampling is used in testing compliance or internal control over compliance.
- Form and content of the schedules of prior year audit findings and corrective action plan.
- Submission of reports to the Federal Audit Clearinghouse.
- Requirement to submit the data collection form.
- Report due dates.

COVID-19 and Single Audits. The federal government's response to the ongoing novel coronavirus (COVID-19) pandemic has been unprecedented, resulting in significant federal financial assistance to individuals, small businesses, nonprofit organizations, schools, health care entities, state and local governments, among others. This funding, which may be received directly or indirectly, will require many entities that have historically received little to no federal funding to be subject to a single audit for the first time. Other organizations that routinely qualify for a single audit due to the $750,000 federal expenditure threshold will likely have new COVID-19-related programs and additional COVID-19-related funding to existing programs. OMB has allowed federal agencies to provide certain additional flexibilities and waivers of compliance requirements in existing programs. As the situation continues to evolve, it is imperative that grantees and their auditors stay up-to-date on legislative and agency activities as well as the related compliance requirements that are triggered by these awards. Auditors need to consider risks associated with the COVID-19 pandemic and related awards as they plan and perform their single audits.

AICPA Audit Guide

The AICPA Audit Guide, *Government Auditing Standards and Single Audits* (the GAS/SA Audit Guide) provides guidance for financial statement audits performed under *Government Auditing Standards* (Part I), and audits conducted in accordance with the Single Audit Act and the Uniform Guidance (Part II).

The guidance in Part I of the GAS/SA Audit Guide for performing audits in accordance with *Government Auditing Standards* applies to *all* HUD audits. Guidance for audits conducted under the Single Audit Act and the Uniform Guidance is provided in Part II (Chapters 5 to 14) of the GAS/SA Audit Guide. This guidance directly applies to Single Audits of nonprofit HUD-assisted entities.

While the guidance in Part II of the GAS/SA Audit Guide is not directly applicable to audits of for-profit HUD entities because the compliance audit for those entities is performed in accordance with the HUD audit guide rather than the Uniform Guidance, the authors believe much of the general guidance in those chapters on aspects of compliance audits also should be considered in for-profit audits. Accordingly, the guidance provided by the GAS/SA Audit Guide is incorporated in this course where applicable.

The 2022 edition of the GAS/SA Audit Guide includes the requirements and guidance from SAS No. 142, updated reporting guidance and illustrations, as well as the amendments included in the 2021 Compliance Supplement.

PPC's Government Documents Library

In order to provide our subscribers with the most recent government documents, a compendium of government documents is provided in *PPC's Government Documents Library* (Library). The Library is available on Checkpoint and may be accessed free of charge. (Customers who do not have Checkpoint access to *PPC's Guide to HUD Audits* and would like to request free access to the Library should send an email to **rg.customerservice@thomsonreuters.com**. Detailed instructions on obtaining free access to the Library are included with the print edition of *PPC's Guide to HUD Audits*.) The authors update the website version of the Library periodically—as necessary to keep the documents current.

AUDITORS' INVOLVEMENT WITH HUD CLIENTS

How Are Auditors Selected?

HUD Handbook 4370.2 REV-1, Paragraph 3-1, states that owners of HUD-assisted projects should use competitive bidding when selecting an auditor. The bidding process can vary based on the size and needs of the project and may range from simple telephone bidding (of at least three auditors) to a request for proposal (RFP).

Auditors interested in participating in the selection process may contact their area HUD field offices, which maintain a database of all existing and development stage HUD projects. Many HUD field offices also list the projects under their supervision on the Internet. Also, as stated earlier in this lesson, the Division of Elderly and Assisted Housing will, upon request, provide information on prospective projects for the elderly and disabled, which auditors can use for practice development purposes.

Other Opportunities for Client Service

As construction of a project nears completion, developers must submit to HUD "cut-off" financial statements and a "Mortgagor's Certificate of Actual Costs" (Form HUD-92330). Audits of the financial statements and Form HUD-92330 are called *cost certification audits*. Chapter 5 of the HUD audit guide provides guidance on performing cost certification audits. This course does not provide detailed guidance on performing cost certification audits. However, *PPC's Guide to HUD Audits* discusses factors to consider when reporting the results of a cost certification audit and includes an illustrative auditor's report.

Other opportunities for client service that should not be overlooked include assisting the client to complete and electronically submit the project owner's financial report to HUD's REAC, performing the required agreed-upon procedure engagement relating to the electronic submission, or preparing the tax return for the entity that owns the HUD project.

STEPS IN THE PPC AUDIT PROCESS

Generally accepted auditing standards require auditors to use information gathered about the entity and its environment (including internal control) to identify and assess the risks of material misstatement at both the overall financial statement and relevant assertion levels, and to determine the nature, timing, and extent of further audit procedures needed to respond to those risks. Further audit procedures are required to be performed to obtain audit evidence to support the auditor's opinion.

The authors have developed a practical approach to that audit process to address the requirements of authoritative literature and have designed practice aids (available in *PPC's Guide to HUD Audits*) to assist auditors in meeting those requirements. PPC's audit approach is designed to be flexible and adaptable, allowing auditors to better leverage their knowledge of the client to tailor their audit procedures. PPC has tailored this approach for use in all of our industry audit guides so that auditors can use a common audit approach in all of their audits. The audit approach has been divided into the following broad steps:

Step 1 Perform procedures regarding acceptance/continuance of the client relationship, evaluate compliance with ethical requirements (including independence), and establish an understanding with the client in an engagement letter.

Step 2 Develop a preliminary audit strategy, establish planning materiality and perform risk assessment procedures to gather information about the entity and its environment that may be relevant in identifying risks of material misstatement/noncompliance.

Step 3 Gather the information to understand and evaluate the design and implementation of the entity's internal control system.

Step 4 Synthesize the information gathered, identify risks (both overall and specific risks) that could result in a material misstatement/noncompliance and finalize the overall audit strategy.

Step 5 Assess the risks of material misstatement of the entity's financial statements.

Step 6 Develop and perform appropriate responses (further audit procedures) to the assessed risks of material misstatement/noncompliance considering the overall audit strategy and planning materiality.

Step 7 Evaluate audit findings and evidence.

Step 8 Prepare required reports and communications.

Although the requirements and guidance may suggest a sequential process, the audit is a continuous process of gathering, updating, and analyzing information about the fairness of presentation of amounts and disclosures in the client's financial statements. Therefore, the audit process is an iterative, nonlinear process, whereby the required procedures may be performed concurrently with other procedures. In addition, risks should be evaluated continuously throughout the audit.

Practice Aids

PPC's Guide to HUD Audits contains practice aids that guide the auditor through the entire audit process. The practice aids included in that guide are discussed in the related text guidance. By using such practice aids, auditors can efficiently conduct an audit of a HUD-assisted entity in accordance with authoritative literature.

Practice aids assist auditors in complying with professional standards and achieving an efficient workflow. Practice aids should be completed on each engagement to fulfill specific professional standards. Practitioners should evaluate which practice aids generally, by themselves, do not fulfill a specific GAAS, Yellow Book, HUD audit guide, and/or Single Audit requirement, and which practice aids assist auditors in situations that do not occur on every audit.

The auditor may choose to document audit procedures in a memo or in another form rather than using a PPC practice aid. To ensure that the alternative documentation meets professional standards, the authors recommend that auditors read the practice aid for an indication of the matters to be considered and documented.

PPC Workflow Tools. Thomson Reuters offers the following tools may provide even more efficiency when conducting an audit of a HUD entity:

- *PPC's Practice Aids.* PPC's *Practice Aids for HUD Audits* contains Word and Excel versions of editable practice aids that can be easily customized for each engagement.

- *PPC's SMART Practice Aids* bring advanced functionality to practice aids, including automatic generation of tailored audit programs based on the risk assessment for each client engagement.

- *Checkpoint Engage* is a fully integrated online audit solution that provides increased audit efficiency and quality.
- PPC's *SMART Practice Aids—Single Audit Suite* allows the planning and execution of the entire Single Audit engagement from beginning to end—including preparation and electronic signoff of practice aids, Federal Award Audit Programs, and Compliance Audit Programs. In addition, it automates the process of determining major programs, low-risk auditee status, and appropriate compliance requirements and prepares the compliance audit program and schedule of expenditures of federal awards for Single Audits.
- *Disclosure Libraries.* PPC's *Interactive Disclosure Library for Nonpublic Companies* is an electronic version of a disclosure checklist that provides hundreds of real-world disclosure examples illustrating disclosures required by GAAP that can easily be pasted into a for-profit entity's financial statements. PPC's *Interactive Disclosure Library for Nonprofit Organizations* is an electronic version of a disclosure checklist tailored for nonprofit entities.
- *PPC's Engagement Letter Generator* is interactive software that automates the process of drafting engagement letters.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

5. In addition to the general literature under GAAP and GAAS, audits of HUD programs are conducted in accordance with which of the following standards?

   a. Office of Multifamily Housing Assistance Restructuring (OMHAR) standards.

   b. Generally accepted government auditing standards (GAGAS).

   c. The coinsured mortgages legislation of 1974.

   d. Federal Housing Administration (FHA) regulations.

6. As described in this course, what is the first step in the PPC audit approach?

   a. Evaluate the entity's internal control system.

   b. Develop a preliminary audit strategy.

   c. Assess the risks of material misstatement.

   d. Perform acceptance/continuance procedures.

SELF STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

5. In addition to the general literature under GAAP and GAAS, audits of HUD programs are conducted in accordance with which of the following standards? **(Page 20)**

   a. Office of Multifamily Housing Assistance Restructuring (OMHAR) standards. [This answer is incorrect. The Office of Recapitalization was created in 2014 to absorb the Office of Affordable Housing Preservation, the administrator of the M2M program after the legislative sunset of the OMHAR. Since audits of HUD programs are conducted in accordance with *active* standards, a different answer applies.]

   b. **Generally accepted government auditing standards (GAGAS). [This answer is correct. Audits of HUD programs are conducted in accordance with GAGAS as specified in the Government Accountability Office's (GAO) *Government Auditing Standards*, often referred to as the "Yellow Book." The Yellow Book standards relate to scope and quality of audit efforts and to the characteristics of a professional and meaningful audit report.]**

   c. The coinsured mortgages legislation of 1974. [This answer is incorrect. Housing legislation enacted in 1974 authorized HUD to coinsure mortgages with approved coinsuring lenders. Under the programs, coinsuring lenders agreed to abide by HUD's requirements, perform HUD's normal loan underwriting functions, and share a portion of the risk of loss. Many project owners and coinsuring lenders were unable to honor their financial obligations, however, causing HUD to sustain large losses. As a result, HUD terminated its coinsurance programs in 1990. The standards described above are active, however, so a different answer choice is needed.]

   d. Federal Housing Administration (FHA) regulations. [This answer is incorrect. The FHA insures loans originated by HUD-approved lenders such as banks, savings and loans, and mortgage companies to finance the purchase of single family and multifamily housing. It does not provide the standards under which audits of HUD programs are conducted.]

6. As described in this course, what is the first step in the PPC audit approach? **(Page 27)**

   a. Evaluate the entity's internal control system. [This answer is incorrect. Gathering the information to understand and evaluate the design and implementation of the entity's internal control system is Step 3 in the PPC audit approach, not the first step.]

   b. Develop a preliminary audit strategy. [This answer is incorrect. Although one of the steps in the PPC audit process is to develop a preliminary audit strategy, including establishing planning materiality and performing risk assessment procedures to gather information about the entity and its environment that may be relevant in identifying risks of material misstatement/noncompliance, it is not the first step.]

   c. Assess the risks of material misstatement. [This answer is incorrect. Assessing the risks of material misstatement of the entity's financial statements is Step 5 in the PPC audit approach. Several steps occur before this one.]

   d. **Perform acceptance/continuance procedures. [This answer is correct. Performing procedures regarding acceptance/continuance of the client relationship is Step 1 in the PPC audit approach. This step also includes evaluating compliance with ethical requirements (including independence), and establishing an understanding with the client in an engagement letter.]**

Lesson 2: Concluding a HUD Audit

INTRODUCTION

This lesson discusses the auditor's requirements and responsibilities when concluding a HUD audit. In addition to the many complex procedures that may be required during different types of HUD engagements, other procedures that are more general in nature are necessary. This lesson discusses the following general and concluding procedures:

- Commitments and contingencies, including litigation, claims, and assessments; environmental remediation liabilities; and risks and uncertainties.
- Accounting estimates and fair value.
- Subsequent events review.
- Related parties.
- Going concern considerations.
- Written representations.
- Considering accumulated results of audit procedures.
- Analytical procedures.
- Review of workpapers.
- Summarization and evaluation.
- Drafting financial statements and the auditor's report.
- Auditor's report on financial statements prepared as a part of a cost certification audit.
- Exit conference and client communications.
- Workpaper finalization and retention.
- Subsequent discovery of matters after the date of the report.

The authors have consolidated much of the audit information from *PPC's Guide to Audits of Nonpublic Companies* and tailored it specifically to address the unique problems, circumstances, and audit approaches common to HUD entities. For a greater understanding of HUD audits in general, users of this course can consult *PPC's Guide to HUD Audits*. It also may be helpful for practitioners to maintain a current edition of *PPC's Guide to Audits of Nonpublic Companies* because the guidance in that publication complements and amplifies *PPC's Guide to HUD Audits*. Auditors of nonprofit HUD entities ought to also maintain a current edition of *PPC's Guide to Single Audits*.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify methods for addressing commitments and contingencies, accounting estimates and fair value, subsequent events, and related parties in HUD engagements.
- Recognize going concern considerations and the written representations needed in a HUD audit.
- Determine how to address the accumulated results of audit procedures, analytical procedures, workpaper review, and summarization and evaluation tasks.

- Recognize best practices for drafting financial statements and the auditor's report, the exit conference, required communications, finalizing and retaining workpapers, and addressing matters discovered after the report date.

Authoritative Literature

The authoritative literature that establishes requirements or provides suggestions that most directly affect the general procedures include the following:

- AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, provides requirements and application and other explanatory material to the auditor and engagement partner as they relate to each element of quality control during the performance of an audit of financial statements.
- AU-C 230, *Audit Documentation*, requires the auditor to document significant findings or issues, the actions taken to address them (and the evidence obtained), and the basis for the auditor's conclusions. In addition, AU-C 230 establishes requirements for documenting the auditor's review and finalizing and retaining audit workpapers.
- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to identify and assess risks of material misstatement due to fraud. In addition, AU-C 240 includes requirements for the evaluation of audit findings for indication of possible fraud and for communications with client management.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, addresses the auditor's responsibility to consider laws and regulations in an audit of financial statements.
- AU-C 260, *The Auditor's Communication with Those Charged with Governance*, requires communication of certain matters to those charged with governance in an audit of financial statements.
- AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, requires written communication of significant deficiencies and material weaknesses to management and those charged with governance.
- AU-C 300, *Planning an Audit*, establishes broad requirements for review of the work of assistants.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, requires the auditor to evaluate the sufficiency and appropriateness of audit evidence obtained.
- AU-C 450, *Evaluation of Misstatements Identified During the Audit*, establishes requirements for the evaluation and communication of audit findings, including the analysis and aggregation of misstatements and documentation of the auditor's conclusion.
- AU-C 501A, *Audit Evidence—Specific Considerations for Selected Items*, identifies the procedures to search for contingencies and establishes requirements for obtaining information from a client's lawyers.
- AU-C 520, *Analytical Procedures*, requires the use of analytical procedures in the review stage of all audits.
- AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides guidance and establishes standards on auditing accounting estimates, including fair value accounting estimates and disclosures contained in financial statements.
- AU-C 550, *Related Parties*, addresses the auditor's responsibilities relating to related party relationships and transactions.
- AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, describes the audit procedures that should be used to identify subsequent events that have a material effect on the financial statements.

- AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, gives guidance on the auditor's responsibility to evaluate whether there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- AU-C 580, *Written Representations*, requires that the auditor obtain certain representations from management.
- AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*, addresses situations when auditors determine subsequent to the date of the report that certain necessary audit procedures were omitted from the audit.
- AU-C 935, *Compliance Audits*, provides guidance on applying GAAS in a compliance audit performed in accordance with generally accepted auditing standards, *Government Auditing Standards*, and a governmental audit requirement that requires an opinion on compliance.
- Statement on Quality Control Standards (SQCS) No. 8, *A Firm's System of Quality Control (QM 10A)*, establishes several requirements for policies and procedures related to concluding the audit, including matters related to review of workpapers and consultation on technical issues.
- *GAO Government Auditing Standards, 2018 Revision Technical Update April 2021* (the Yellow Book).
- (For-profit audits) *Consolidated Audit Guide for Audits of HUD Programs* (HUD audit guide) issued by the HUD Office of Inspector General.
- (Nonprofit audits) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) issued by the Office of Management and Budget (OMB).
- AICPA Audit Guide, *Government Auditing Standards and Single Audits*.

Literature Specific to HUD Entities

HUD Audit Guide (For-profit Audits). In addition to GAAS and *Government Auditing Standards*, audits of for-profit HUD entities must comply with the *Consolidated Audit Guide for Audits of HUD Programs* (the HUD audit guide) issued by the HUD Office of Inspector General. HUD requirements are highlighted and discussed where applicable throughout this lesson. Also, see Lesson 1 for a discussion of HUD literature.

The requirements in Chapter 1 of the HUD audit guide that affect concluding audit activities in a HUD audit include:

- Specification of certain items to be included in the management representation letter.
- Additional communication requirements when noncompliance with provisions of laws, regulations, contracts, and grant agreements, or fraud has occurred or is likely to have occurred.
- Additional communication requirements when the client terminates the audit or the auditor withdraws from the audit engagement.
- Expanded audit documentation retention requirements.

The requirements are discussed where applicable throughout this lesson.

Applicability of the AICPA Audit Guide. The AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), presents guidance for financial statement audits performed under *Government Auditing Standards* in Part I. This guidance applies to all HUD audits, both for-profit and nonprofit audits. The GAS/SA Audit Guide provides guidance for compliance audits conducted under the Single Audit Act and the Uniform Guidance in Part II. Although the guidance in Part II only specifically applies to Single Audits of HUD nonprofit entities, the authors believe that much of the general guidance in Part II for performing compliance audits ought to be considered in all HUD audits and have incorporated it in this lesson where relevant. This course reflects guidance available in the April 2022 edition of the GAS/SA Audit Guide.

DEALING WITH COMMITMENTS AND CONTINGENCIES

The primary audit objectives for commitments and contingencies are discovering their existence, assessing their financial statement effect, and evaluating the presentation or disclosure matters for the assertions of related classes of transactions, events, or account balances. Examples of commitments and contingencies of concern to a HUD auditor are as follows:

- Fraud and violations of laws or regulations involving management or employees that could affect HUD programs.
- Other noncompliance with provisions of laws, regulations, contracts, and grant agreements applicable to federal programs, including communications from HUD or other regulatory agencies concerning violations or possible violations of such laws or regulations, or possible claims for disallowed costs.
- Pending or threatened litigation or unasserted claims.
- Long-term leases with required fixed payments for several years.
- Commitments related to expansion or rehabilitation of facilities.
- Purchase commitments.
- Anticipated losses on long-term contracts.
- Financial transactions or arrangements with financial institutions, e.g., oral or written guarantees, endorsements, open letters of credit, etc.
- Disputes relating to IRS examinations in progress.
- Other oral or written guarantees.
- Environmental remediation liabilities.

Audit Procedures

The auditor may be aware of possible commitments or contingencies from knowledge of the entity's activities gained during audit planning and from reading minutes, contracts, regulatory agreements, or other documents. Some commitments or contingencies may be discovered as a result of audit procedures applied to specific account balances or transaction classes. For example, lease commitments may be discovered during the audit of rent and other lease payments, and compensating balance or debt guarantee arrangements may be disclosed in specific confirmation responses received from lenders.

The auditor may decide to send confirmation letters to financial institutions to confirm or discover details of financing arrangements, such as guarantees or other contingent liabilities. The auditor should specifically question management about the possibility of unrecorded contingencies or commitments. The management and letter of inquiry sent to the entity's legal counsel also provides evidence about commitments and contingencies.

Litigation, Claims, and Assessments

AU-C 501A, *Audit Evidence—Specific Considerations for Selected Items*, among other topics, addresses the procedures that auditors should follow for identifying an entity's litigation, claims, and assessments that may result in a risk of material misstatement. The authoritative guidance related to litigation, claims, and assessments is found in paragraphs AU-C 501A.03, 501A.16–.24 and application guidance is found in paragraphs 501A.A39–.A65. Additionally, AU-C 501A.A69 provides an illustrative audit inquiry letter to legal counsel.

AU-C 501A.18 requires the auditor to seek direct communication with the entity's legal counsel unless the procedures performed to identify litigation, claims, and assessments do not indicate any actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement. The auditor identifies lawyers who were consulted about litigation, claims, and assessments and to whom a letter of inquiry may be sent. These lawyers are identified by reviewing client legal files, analyzing legal and professional fees and invoices, and inquiring of management. In the situation where the auditor does not seek direct communication with the entity's legal counsel, the auditor should document the basis for that decision.

Client Has Not Consulted a Lawyer. In some engagements, management has had no need to consult a lawyer about pending or threatened litigation or claims. (However, a lawyer may have been consulted for other reasons, such as matters related to collection of receivables, drafting of contracts, etc.) As long as the entity has no material litigation, claims, or assessments, it is generally not necessary to request a legal representation letter. An auditor can rely on other audit procedures, as described above, to disclose the existence of contingencies, including litigation, claims, and assessments. If an auditor's other procedures do not identify the existence of material claims or assessments, nor indicate that a lawyer was consulted regarding such matters, no additional procedures are necessary. However, the authors recommend that the written representation obtained from management as it relates to litigation, claims, and assessments be modified to state that management has not consulted with an attorney. This representation would take the place of those representations ordinarily obtained about litigation, claims, and assessments.

In some situations, if the auditor believes that actual or potential material litigation, claims, or assessments possibly exist, but the entity has not engaged external legal counsel relating to such matters, the auditor may discuss with the client the need to consult legal counsel to appropriately determine the effect on the entity's financial statements. If the auditor believes the matter may be significant, refusal by management to consult legal counsel may result in a scope limitation sufficient enough to preclude an unmodified opinion.

Content of the Legal Representation Letter. The letter is from the client (with the auditor controlling mailing the letter) and asks the lawyer to provide or corroborate information about pending or threatened litigation, including its nature and progress to date; how the entity is responding or intends to respond; the likelihood of an unfavorable outcome; an estimate, if one can be made, of the amount or range of potential loss; and a statement that the list of matters is complete or an identification of any pending or threatened litigation, claims, and assessments that were omitted. This information needs to be obtained for each individual case for which legal counsel has devoted substantive legal consultation or representation on behalf of the entity. A collective evaluation is not sufficient except when the lawyer handling the litigation has evaluated the litigation in the aggregate in accordance with materiality limits specified by the auditor.

The approach to unasserted claims is indirect. Lawyers will not furnish an auditor with information on unasserted claims and assessments because of concern about preserving the attorney-client privilege, nor will they confirm the completeness of information furnished by management. Assurance is obtained indirectly by the following process:

- The lawyer is asked to confirm that whenever the lawyer is aware of an unasserted claim requiring disclosure according to FASB ASC 450, *Contingencies*, the lawyer will advise the client.
- Management is asked to represent to the auditor that management has informed the auditor of any claims the lawyer has advised are required to be disclosed. (Usually this representation is obtained in a management representation letter.)
- The auditor informs the lawyer of management's representation on unasserted claims. (Usually, this is covered in the inquiry letter to the lawyer, and normally, especially in a small HUD entity, the representation is that there are no unasserted claims.)

The letter should specify a materiality limit so that the lawyer knows what items are to be considered material, individually or in the aggregate, for purposes of the response. The materiality amount used is generally some fraction of performance materiality. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors.

Auditors can send a request for legal representation with a list prepared by the entity's management (Long-form) in which the lawyer is asked to comment on the completeness of client-prepared information about the details of each matter listed as pending or threatened litigation. This approach may be more efficient if the entity has both inside and outside legal counsel. The inside legal counsel may be able to prepare the information and thus reduce the cost of obtaining outside counsel's representations. Another option is to send a request for legal representation with a list prepared by the entity's lawyer (Short-form) in which the lawyer is asked to prepare information rather than comment on management's list. The American Bar Association has expressed a preference for this approach and, as a practical matter, a client-prepared list is prepared with the lawyer's advice. This form is usually best suited for a small project, especially if the entity does not have inside counsel.

Evaluating Lawyers' Responses. In reviewing the lawyer's response, the auditor should make sure it reflects the materiality limit specified, is as of the specified response date, and contains all items of information requested (if a short form request was sent). If the date of the response significantly differs from the date requested, the auditor should obtain an updated letter. Also, the auditor needs to carefully evaluate how the lawyer words the assessment of the probability of an unfavorable outcome. The auditor needs to decide whether the response is clear regarding a probable or remote outcome. Wording such as "the client believes there is absolutely no merit to the litigation," "the client has a substantial chance of prevailing," or "the client will be able to assert meritorious defenses," are not clear as to likelihood of outcome. In addition, lawyers' responses that are unclear or amount to talking around the point without taking a solid position need to be carefully evaluated by the auditor. For example, terms like *substantial chance* and *reasonable opportunity* indicate more uncertainty than an opinion that the HUD entity will prevail. The term *meritorious defenses* means only that the defenses will not be summarily dismissed by the court.

In some instances, the attorney may limit his or her response in ways other than specified by the original request. For example, instead of limiting the response based on a specified materiality limit, the attorney may limit the response to cases in which six or more hours have been billed. In that situation, the auditor needs to assess the potential effect of the limitation on the attorney's response. A limitation based on billable hours is generally not appropriate because it does not necessarily correlate to the amount of the contingent liability. Consequently, if an attorney's response has a billable hours limitation, the auditor will generally need to ask the client to have the attorney respond based on the materiality limits specified in the original request.

Some lawyers add statements in their responses to emphasize retention of the attorney-client and attorney work product privileges. An example of such statements follows:

> [Name of HUD entity] has advised us that the request made in its letter to us is not intended to be a waiver of the attorney-client privilege relating to any information that has been furnished to us. Furthermore, be advised that our response to you should not be interpreted as a waiver of the protection of the attorney work product privilege relating to any of our files involving [Name of HUD entity] .

According to AU-C 501A.A61, such comments in lawyers' letters are not limitations on the scope of their responses. Thus, those comments do not affect the auditors' evaluations.

With respect to unasserted possible claims or assessments, some attorneys also include language such as the following in their responses to emphasize the preservation of attorney-client privilege:

> Please be advised that pursuant to clauses (b) and (c) of Paragraph 5 of the ABA Statement of Policy and related Commentary referred to in the last paragraph of this letter, it would be inappropriate for this firm to respond to a general inquiry relating to the existence of unasserted possible claims or assessments involving our client. We can only furnish information concerning those unasserted possible claims or assessments upon which our client has specifically requested in writing that we comment. We also cannot comment upon the adequacy of our client's listing, if any, of unasserted possible claims or assessments or its assertions concerning the advice, if any, about the need to disclose same.

According to AU-C 501A.A62, such language is not a limitation on the scope of the audit as long as the lawyer's response includes a confirmation of the understanding that the lawyer, under certain circumstances, will advise and consult with the client concerning the client's obligation to make financial statement disclosure with respect to unasserted claims or assessments.

If the auditor obtains an oral response concerning matters covered by the audit inquiry letter, the auditor should document conclusions reached and the basis for that conclusion provided by the legal counsel's oral response concerning the need to account for or disclose litigation, claims, and assessments.

Dating of Lawyer's Response. The letter from the client's lawyer needs to be coordinated with the date of the auditor's report. Accordingly, it is preferable for the letter to be dated to cover a period that closely corresponds to the auditor's report date, usually within two weeks of the report date. (In some circumstances, e.g., when there are volatile litigation proceedings, the auditor might want to confirm the continued appropriateness of the lawyer's response as of a date nearer to the report date.) If the attorney's response does not specify an effective date, the auditor can assume that the date of the response is the effective date. If the lawyer's response is dated too long before the date of the auditor's report, the auditor needs to consider getting an updated response, either oral or written. If the update is obtained orally, it should be documented in the workpapers. If significant matters (such as new litigation or significant developments relating to old litigation) are discovered in the oral update, the authors recommend obtaining a written update from the attorney.

Scope Limitations Related to Litigation, Claims, and Assessments. If an external legal counsel refuses to furnish the information requested in an audit inquiry letter, either in writing or orally, according to AU-C 501A.A58, that may cause a scope limitation of the audit sufficient to preclude an unmodified opinion. The limitations inherent in the form of inquiry described by AU-C 501A.22 are not scope limitations. Information on pending or threatened litigation, claims, and assessments is appropriately limited to matters as to which the legal counsel has been engaged and to which the legal counsel has devoted substantive attention.

As explained above, the legal counsel does not provide information on the existence of unasserted claims and might further include language in the response to preserve lawyer-client privilege. This language does not constitute a scope limitation. Maintaining privilege is the same reason the legal counsel is not requested to provide a list of unasserted claims and to comment only on such matters the client has already disclosed to the auditor.

Because of the lawyer-client privilege, the client might identify certain documents as subject to the lawyer-client privilege and not permit the auditor to examine them. Whether this would be considered a scope limitation depends on the circumstances. AU-C 501A.A59 points out that if there are such questions about the applicability of the privilege, the auditor may request legal counsel's confirmation that the information is subject to that privilege and that the information was considered by the legal counsel in responding to the letter of inquiry. The authors believe that unless the auditor is able to obtain such confirmation, the matter does constitute a scope limitation.

As noted in AU-C 501A.A60, if management imposes a scope limitation on the audit and the auditor cannot obtain sufficient appropriate audit evidence through alternative procedures, a disclaimer of opinion should be rendered or, when practical, the auditor might withdraw from the engagement.

Environmental Remediation Liabilities

Environmental remediation liabilities are a specific type of contingent liability that presents an auditing challenge for many firms because of the number of applicable state and federal laws, the number of industries affected, and the possibility that many years may elapse between the contamination event and identification of the liability. Guidance on accounting for environmental remediation liabilities is provided by FASB ASC 410, *Asset Retirement and Environmental Obligations*. *PPC's Guide to Preparing Financial Statements* provides an in-depth discussion of environmental laws and accounting for environmental remediation liabilities.

Accounting Standards. FASB ASC 450, *Contingencies*, requires that a loss contingency be recorded if it is probable that a liability has been incurred at the date of the financial statements and the amount of the loss is estimable. Due to the number of steps involved in an environmental remediation and the time period covered, it may be difficult for an entity to estimate its liability. When attempting to reasonably estimate the loss, FASB ASC 450-20 should be applied. The guidance makes it clear that if no single loss amount can be estimated, a range of loss should be used. If a number within the range is considered a best estimate, that amount should be accrued. Otherwise, the minimum amount in the range should be accrued.

Some auditors believe that the strict liability provisions of federal Superfund Laws make it probable that an entity has incurred a liability if it is associated with a site for which a claim or assessment has been asserted (or is probable of assertion). The authors believe that an auditor will evaluate each case based on the site's individual facts and circumstances. However, if a client has been notified that it is a potentially responsible party (PRP) for a site, any conclusion that the entity's risk of loss is other than probable ought to be carefully considered and documented.

Audit Procedures. To identify instances of noncompliance with laws and regulations (such as environmental regulations) that may have a material effect on the financial statements, in accordance with AU-C 250.14, auditors should (a) inquire of management and, when appropriate, those charged with governance about whether the entity is in compliance with such laws and regulations and (b) inspect correspondence, if any, with the appropriate licensing or regulatory authorities. The extent of other procedures performed for environmental liabilities depends on the entity's potential to incur such liabilities. If there is an increased risk that the HUD entity has environmental remediation liabilities, auditing procedures generally are the same procedures applied for other contingent liabilities (that is, reading the minutes of board or administrative committee meetings, making inquiries of the client's attorney, and making inquiries of the client). Some of the inquiries auditors may make of management when an increased risk is identified include whether they have:

- Considered environmental matters that may materially affect the financial statements.
- Established effective policies and procedures to assess and record information on environmental matters.
- Been notified that the entity has been designated as a PRP or otherwise has an increased risk of exposure to environmental liabilities.

Auditors frequently obtain information about potential environmental liabilities through the lawyer's response. If the entity has been notified by a federal regulator that a potential liability exists for a site with which it is or has been associated, the auditor would normally probe through additional inquiry and analysis of a conclusion by the entity's attorney that the risk of loss is other than probable.

Auditing the Estimated Liability. If a HUD project has been designated a PRP or has an increased risk of exposure, the auditor obtains an understanding of the method used to estimate the liability. The next section in this lesson provides guidance on auditing accounting estimates. If the client uses an attorney, engineer, or other specialist to make the estimate, the guidance in AU-C 500.08 on use of a management's specialist should be followed. AU-C 500.08 requires the auditor to:

- Evaluate the competence, capabilities, and objectivity of the specialist.
- Obtain an understanding of the specialist's work.
- Evaluate the appropriateness of the work as audit evidence for the relevant assertion.

Auditors may also consider information such as the following when assessing the adequacy of the client's estimate:

- The client's previous cleanup experience, if any.
- The cleanup experiences of other companies in similar circumstances.
- Data released by the EPA or other organizations.

Applicability to HUD Project Owners. Although typically thought of in relation to manufacturing plants or service stations, environmental remediation could be faced by a project owner. For example, entities are not just liable for cleaning up the waste they generated, disposed of, stored, or hauled—they may also be liable for cleaning up sites they did not contaminate. For example, if a multifamily housing project was constructed on a land site that had been contaminated by the previous owner, the project owner may become liable for the site's cleanup. The project could also have become contaminated by the use of hazardous building materials, such as asbestos.

Risks and Uncertainties

FASB ASC 275, *Risks and Uncertainties*, requires disclosures about risks and uncertainties that could significantly affect the amounts or situations reported in the financial statements. Disclosure is required in the following four areas:

- Nature of operations.
- Use of estimates in the preparation of financial statements.

- Certain significant estimates.
- Current vulnerability due to concentrations.

The first two disclosures generally are required for all financial statements. The second two are required only for estimates and concentrations that meet specified criteria. These disclosures are not required for condensed or summarized interim financial statements. The first two areas do not require significant additional audit work because the disclosures are required in all financial statements and the information needed for the disclosures is readily available. However, for the other two areas, generally require specific audit procedures to determine that all required disclosures have been identified.

COVID-19 Risks and Uncertainties Considerations. COVID-19 has disrupted most aspects of life around the world and has many implications for auditing, in particular the introduction of numerous risks and uncertainties that may not have existed in the past. To help auditors identify and address those implications for the audit, the authors recommend that practitioners review a list of factors related to the COVID-19 pandemic when considering potential risks and uncertainties.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to respond to any COVID-19 related audit issues. The AICPA has, however, provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the accounting and auditing issues created.

Certain Significant Estimates. Initially, an auditor's objective is to determine whether all significant estimates have been identified. One way of determining the existence of a significant estimate that requires disclosure is to answer the following questions:

- Was an estimate used in preparing the financial statements?
- Is there more than a remote possibility that the estimate will change by a material amount within one year from the date of the financial statements due to a condition that existed at the date of the financial statements?

AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides guidance that is useful. It requires that the auditor obtain an understanding, through the performance of risk assessment procedures, of how management identifies those transactions, events, and conditions that may require accounting estimates. When doing so, the auditor is required to make inquiries of management about changes in circumstances that may result in new or changed estimates. The exhibit to AU-C 540A provides numerous examples of accounting estimates that are included in financial statements.

The auditor's consideration of whether all significant estimates were identified can be documented in the audit program. Representations the auditor may obtain related to significant estimates can be recorded in the representation letter. Further discussion about auditing accounting estimates appears later in this lesson.

The next step is determining whether it is at least reasonably possible that an estimate will change in the near term. The term *reasonably possible* encompasses the entire range from "more than remote" to "less than likely." It could be concluded that it is at least reasonably possible that almost any estimate could change. To conclude otherwise, an auditor would have to conclude that there is only a *remote* chance of an estimate changing.

AU-C 540A.22 notes that the auditor is required to document the basis for conclusions pertaining to the reasonableness of accounting estimates and their disclosure where there are significant risks. If an auditor concludes there is only a remote chance of an estimate changing, the authors believe it is good practice to document such conclusions, particularly if the decisions are difficult or contentious. Such documentation can be informal and can be done, for example, on the relevant workpaper or in a separate memo. Note that even if it is determined that the chances of an estimate changing are more than remote, the remaining criteria—"material amount," "near term," and "existing conditions"—may still eliminate the need for disclosure. Further information about what an auditor should consider relative to significant estimates is provided in *PPC's Guide to Audits of Nonpublic Companies*.

Current Vulnerability Resulting from Certain Concentrations. The audit approach for concentrations is similar in many respects to the audit approach for significant estimates. That is, initially, the auditor's objective is to determine whether all concentrations have been identified. If the auditor identifies concentrations, evaluation of disclosure can be documented on the relevant workpaper or by memo. One significant difference between auditing disclosures of concentrations and auditing disclosures of significant estimates is that the threshold for disclosure is different. For concentrations, the threshold is *severe impact*, whereas for significant estimates, the threshold is material.

Wording the Disclosure. Applying FASB ASC 275 requires significant judgment on the part of both the auditor and the client. The accounting standards contain only disclosure requirements, and do not require amounts to be recorded in the financial statements. For that reason, an approach of "when in doubt, disclose" is recommended. Some clients may have concerns that the required disclosures will include information considered by management to be confidential. This is particularly true for disclosure of certain concentrations. Other concerns may include that the disclosures are too negative and could place a company at a competitive disadvantage (for example, by providing competitors with information about a company's strategy for reducing excess inventory). The guidance provides flexibility in wording the disclosures, so they can be worded in a manner that does not place the client at a competitive disadvantage. For example, when disclosing a concentration, phrases such as "a significant portion" or "a substantial percentage" are appropriate. The guidance does not require that the disclosure name names and give percentages.

USING ACCOUNTING ESTIMATES AND MEASURING FAIR VALUE

Some financial statement items cannot be measured precisely but can only be estimated. Those items are referred to as *accounting estimates*. Fair value measurements are a type of accounting estimate. Accounting estimates may be recognized in the body of the financial statements (for example, the allowance for doubtful accounts or an impairment adjustment) or only disclosed in the notes (for example, disclosure of the fair value of financial instruments).

COVID-19 Estimates Considerations

COVID-19 has had many implications for auditing, including significant considerations for the auditing of accounting estimates. Auditors may wish to review a list of factors to consider related to the COVID-19 pandemic when performing inquiries about accounting estimates and performing procedures to obtain sufficient appropriate audit evidence and assess the reasonableness of recognized accounting estimates.

The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to respond to any COVID-19 related audit issues. The AICPA has, however, provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the accounting and auditing issues created.

Auditing Accounting Estimates

AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, provides the authoritative guidance for auditing accounting estimates, including fair values.

Preparation of financial statements normally requires making accounting estimates. AU-C 540A.07 discusses an *accounting estimate* in terms of an approximation of a monetary amount when there is not a precise means of measurement. The nature and reliability of information available to management when making estimates will vary. As a result, the degree of estimation uncertainty associated with estimates will vary. The degree of estimation uncertainty affects the risk of material misstatement of estimates. AU-C 540A.07 uses the term *estimation uncertainty* to describe how an accounting estimate and related disclosure are susceptible to an inherent lack of measurement precision.

AU-C 540A.A6 provides the following examples of circumstances when accounting estimates, other than fair value accounting estimates, are relevant to HUD-assisted entities:

- Allowance for doubtful accounts.
- Depreciation methods or asset lives.
- Impairment of an investment.
- Litigation settlements and judgments.

AU-C 540A.A7 provides examples of circumstances when fair value accounting estimates may be required:

- Property or equipment held for disposal.
- Complex financial instruments not traded in an active and open market.
- Certain assets or liabilities acquired in a business combination.
- Certain nonmonetary exchanges.

The exhibit to AU-C 540A provides additional examples of accounting estimates. When recognizing revenue in accordance with FASB ASC 606, *Revenue from Contracts with Customers*, additional estimates may be required, such as estimating variable consideration in the determination of transaction price and estimating the stand-alone selling price in the allocation of transaction price to performance obligations.

When auditing accounting estimates, AU-C 540A emphasizes that the auditor should follow a risk-based approach. Also, the auditor should understand the requirements of GAAP relating to relevant estimates, including the pertinent disclosure requirements. The understanding of GAAP requirements will provide a basis for the auditor's evaluation of management's recognition and measurement of accounting estimates along with related disclosures that may be necessary.

Risk Assessment Procedures and Related Activities. AU-C 540A.08 indicates that the auditor should obtain an understanding of how management identifies and makes accounting estimates through the performance of risk assessment procedures as part of obtaining an understanding of the entity and its environment, including internal control. Specifically, the auditor's understanding should include the following:

- How management identifies transactions, events, and conditions that require accounting estimates.
- How management makes estimates and the underlying data used, including the methods, assumptions, relevant controls, specialists required, changes from prior periods in method or assumptions, and whether and how estimation uncertainty has been assessed.

The auditor is also required to perform a review of the outcome of accounting estimates that were included in the prior period. Generally, the outcome of an accounting estimate will differ from the amount that was recognized in the prior period. By identifying and understanding the reasons for such differences, the auditor may obtain information about the effectiveness of management's prior period estimation process, audit evidence that is pertinent to re-estimation of prior period estimates in the current period, or evidence of matters requiring disclosure in the financial statements such as estimation uncertainty. In addition, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires a retrospective review of management's judgments or assumptions related to significant accounting estimates included in prior period financial statements to determine if there is an indication of management bias and a risk of material misstatement due to fraud. As a practical matter, both reviews can be coordinated when reviewing prior period estimates.

Through the performance of risk assessment procedures and related activities directed towards accounting estimates, the auditor should identify and assess risks associated with the development of accounting estimates. In doing so, the auditor is required to evaluate the degree of estimation uncertainty associated with accounting estimates. The auditor is required to determine if those estimates with high estimation uncertainty represent significant risks. For identified significant risks, the auditor is required to understand the entity's controls, including control activities. Accounting estimates with a higher degree of estimation uncertainty also might be susceptible to management bias.

AU-C 540A.A47 provides examples of accounting estimates that can have high estimation uncertainty. Such estimates might have the following characteristics:

- Highly dependent upon judgment.
- Not calculated using recognized measurement techniques.
- Similar estimates in the prior period had substantial differences from the actual outcome.
- For fair value accounting estimates, a highly specialized, entity-developed model is used or for which there are no observable inputs.

The practice aids in *PPC's Guide to HUD Audits* allow the auditor to meet the requirements associated with risk assessment procedures and related activities for auditing accounting estimates. In addition, *PPC's Guide to Audits of Nonpublic Companies* provides in-depth guidance on auditing accounting estimates.

Auditing Fair Value Measurements and Disclosures

Recent accounting standards indicate a move to providing more fair value information. Under generally accepted accounting principles, fair value measurements are used for specific items in the financial statements or, in some cases, as a comprehensive basis for all items in the financial statements. In addition, GAAP requires disclosures in several areas, such as investments and derivatives and donated materials and services. Fair value measurements of assets, liabilities, and components of net assets may arise from the initial recording of transactions and the subsequent changes in value.

The requirements of AU-C 540A also apply to auditing fair value accounting estimates. Therefore, when the auditor is auditing estimated fair value measurements recognized or disclosed in the financial statements, the general guidance of AU-C 540A relating to risk assessment procedures, identifying and assessing risks, responding to assessed risks including significant risks, as well as other required matters, govern the auditor's procedures.

AU-C 540A establishes requirements and provides guidance for testing fair values. When testing the client's valuation process or developing an independent estimate based on management's assumptions, the auditor should evaluate whether management's assumptions are reasonable and consistent with market information. The auditor considers the source and reliability of evidence supporting the assumptions, pays special attention to assumptions that are highly sensitive or uncertain and those susceptible to misapplication or bias, and considers the sensitivity of the valuation to changes in assumptions and market conditions.

When auditing fair value disclosures, the following guidance applies:

- Evaluation of whether fair value disclosures are in conformity with GAAP ordinarily involves the same audit procedures used to audit fair value measurements recognized in the financial statements.
- If fair value disclosure is omitted because it is not practical to determine fair value with sufficient reliability, information that would be pertinent to such an estimate should be disclosed along with the reasons why it is not practical to estimate fair value. In that case, the adequacy of disclosures required in such circumstances is evaluated.

THE SUBSEQUENT EVENTS REVIEW

AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, defines the types of subsequent events the auditor should evaluate and specifies the procedures that should be performed to determine the occurrence of such events. FASB ASC 855-10, *Subsequent Events*, includes accounting and disclosure standards for subsequent events.

Practitioners may wish to review factors related to the COVID-19 pandemic when performing procedures related to subsequent events. The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to respond to any COVID-19 related audit issues. The AICPA has, however, provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the accounting and auditing issues created.

FASB ASC 855-10-50-1 requires reporting entities to disclose the date through which subsequent events have been evaluated and whether that date is the date the financial statements were issued or were available to be issued. That disclosure is required regardless of whether the reporting entity recognizes or discloses a subsequent event in its financial statements. Generally, nonpublic entities will evaluate subsequent events through the date that the financial statements are available to be issued, i.e., when they are complete in a form and format that complies with GAAP and all approvals necessary for issuance have been obtained. Often, this will be the date of the auditor's final conference with the client when proposed adjustments to the financial statements are agreed upon. Therefore, the remainder of this discussion addresses subsequent events in the context of the date the financial statements are available to be issued.

FASB ASC 855-10-20 notes that subsequent events are events or transactions that occur subsequent to the balance sheet date but before financial statements are available to be issued. The period within this time is called the subsequent events period.

The auditor's report is dated no earlier than the date on which the auditor has obtained sufficient appropriate evidence to support the opinion. This includes evidence about subsequent events, so the auditor's report date cannot be earlier than the date of management's subsequent events evaluation note. AU-C 560.A10, notes that, in most cases, the date of management's subsequent events evaluation note will be the same date as the auditor's report. Furthermore, AU-C 580 requires management to make specific representations relating to information concerning subsequent events, and the date of the management representation letter should be the same as the date of the auditor's report. Therefore, the subsequent events evaluation note date, the management representation letter date, and the auditor's report date generally will be the same. A discussion on coordinating these dates appears later in this lesson.

The date of the auditor's report will be close to the report release date. Many firms adopt a policy about when to date their auditor's report if there is a delay in releasing the report (that is, how long of a delay makes it necessary to redate the report). A decision to redate the report should result in extending the subsequent events review to the later date. Auditors may consider covering that matter in their firm's quality control policies and procedures. Dating of the auditor's report is also discussed later in this lesson.

Types of Subsequent Events

FASB ASC 855 prescribes the accounting for subsequent events that are not addressed in other specific accounting standards. For example, FASB ASC 740-10-25-15 prescribes the accounting treatment for changes in judgment after the balance sheet date that results in subsequent recognition, derecognition, or change in measurement of a tax position taken in a prior annual period. When another accounting standard does not prescribe a different treatment, FASB ASC 855-10-20 delineates the two following types of subsequent events:

a. *Recognized Subsequent Events*—The first type consists of events or transactions that provide additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

b. *Nonrecognized Subsequent Events*—The second type consists of events that provide evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date but before the financial statements are available to be issued.

Subsequent Events Review Procedures

Some subsequent events may be discovered as a result of audit procedures applied for specific financial statement components. These procedures usually involve cutoff tests and assessment of valuation. For example, the inspection of subsequent collections of accounts receivable may disclose a material subsequent event. However, there is a group of procedures performed specifically to search for material subsequent events, the so-called subsequent events review.

According to AU-C 560.10, the auditor should perform subsequent events review procedures that cover the period from the date of the financial statements to the date of the auditor's report or as close to that date as practicable. The audit procedures specifically required by AU-C 560.10 are limited to (a) obtaining an understanding of management's procedures for identifying subsequent events, (b) inquiries, (c) reading minutes, and (d) reading the latest interim financial statements. In practice, auditors typically perform the following procedures:

a. *Understand Management's Procedures.* Auditors obtain an understanding of procedures management has established to ensure that subsequent events are identified.

b. *Inquire of Management and, When Appropriate, Those Charged with Governance.* Auditors inquire about the current status of items that were accounted for based on preliminary or inconclusive data.

c. *Evaluate Evidence about Estimates.* Auditors consider whether events occurring up to the date of the auditor's report provide audit evidence about accounting estimates.

d. *Obtain Lawyer's Letter.* Letters obtained from the client's lawyers cover matters at the balance sheet date through a period specified in the audit inquiry letter that is as close as possible to the audit report date. (AU-C 501A.A53)

e. *Obtain a Management Representation Letter.* Written representations obtained from management should be as of the audit report date.

f. *Read Minutes of Partners' and Directors' Meetings.* Reading minutes should include those available for meetings after the balance sheet date. If minutes (or drafts) are not available for meetings that occur in the subsequent period, inquiries should be made about significant matters dealt with at those meetings.

g. *Read Internal Financial Reports.* Reading internal reports generally includes available interim financial statements or budgets. The purpose of this procedure is to identify any significant changes in operations. In most HUD entities, internal financial reports are not extensive, and an auditor needs to discuss with the owner/manager what information is used to monitor operations.

h. *Scan Journals and Ledgers.* Auditors scan accounting records for the subsequent period for unusual items or significant items related to the current period.

i. *Consider Impairment of Assets.* Auditors consider whether the carrying amount of assets has become impaired subsequent to year end.

Additional procedures may be necessary to follow up on material subsequent events discovered in performing the above procedures. If material subsequent events are discovered, auditors should ensure that the workpapers include the information needed to support adjustments to the financial statements or disclosures about subsequent events (AU-C 560.11).

AU-C 560.A6 suggests that inquiries may include specific inquiries about matters such as the following:

- New commitments, borrowings, or guarantees.
- Planned or executed disposals or acquisitions of assets.
- Issuance of debt or equity securities.
- Agreements or plans to merge or liquidate.
- Appropriation of assets by a government.
- Destruction or extensive damage of assets such as by fire or flood.
- Developments concerning contingencies.

- Unusual accounting adjustments entered or considered.
- Events or potential events calling into question accounting policies, including the going concern assumption, or measurement of estimates.
- Changes in related parties.
- Significant new related party transactions.
- Significant unusual transactions.

Subsequent Discovery of Matters after the Date of the Report

Subsequent to the date of the auditor's report, auditors may become aware of facts that existed on that date that might have caused them to believe information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had they then been aware of them. In such circumstances, the auditor should consider the guidance in AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, in determining an appropriate course of action.

AU-C 560 contains separate requirements for situations where facts are discovered before the report release date and situations where facts are discovered after the report release date. According to AU-C 560.A18, the guidance is applicable even if the auditor has withdrawn or been discharged. *PPC's Guide to Audits of Nonpublic Companies* provides guidance on the auditor's considerations regarding subsequently discovered facts.

Subsequent Events Related to Supplementary Information

At the conclusion of a HUD audit, the entity submits the audited financial data to HUD electronically through FASSUB. A hard copy of the financial report and schedules submitted through FASSUB is presented with the audited financial statements. AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, requires the auditor to report on whether this supplementary information is fairly stated, in all material respects, in relation to the financial statements as a whole. AU-C 725.08 explains that the auditor has no responsibility for the consideration of subsequent events with respect to the supplementary information. However, if information comes to the auditor's attention (a) prior to the release of the auditor's report on the entity's financial statements regarding subsequent events that affect the financial statements; or (b) subsequent to the release of the auditor's report on the financial statements regarding facts that, if known to the auditor at the date of the report, may have caused the auditor to revise the report, the auditor should apply the relevant requirements in AU-C 560.

Subsequent Events Considerations in the Compliance Audit

The auditor's responsibilities regarding subsequent events in a compliance audit are similar to those in a financial statement audit except that the events being considered relate to compliance requirements. In an audit of a for-profit multifamily HUD entity, this assessment is made in relation to the compliance requirements in Chapter 3 of the *Consolidated Audit Guide for Audits of HUD Programs*. Two types of subsequent events require consideration by management and evaluation by the auditor in a compliance audit: (a) events that provide additional information about conditions that existed at the end of the reporting period that affect compliance during the reporting period and (b) events of noncompliance that did not exist at the end of the reporting period but occurred subsequent to the reporting period and before the date of the auditor's report.

AU-C 935.25, *Compliance Audits*, states that subsequent events procedures related to the compliance audit should be performed up to the date of the auditor's report. Additionally, AU-C 935.26 explains that the nature and extent of such procedures should take into account the auditor's risk assessment and should include, but not be limited to, inquiring of management about and considering the following:

- Relevant reports issued by internal auditors during the subsequent period.
- Reports issued by other auditors during the subsequent period that identify noncompliance.
- Reports on the entity's noncompliance that were issued by grantors and pass-through entities during the subsequent period.

- Information about noncompliance obtained through other professional engagements performed for that entity.

AU-C 935.27 explains that the auditor is not required to perform audit procedures related to noncompliance that occurs after the period covered by the auditor's report. However, the auditor should discuss with management and, if appropriate, those charged with governance any such noncompliance that comes to the auditor's attention before the report release date, if due to its nature and significance, disclosure of the noncompliance is necessary to keep the auditor's report on compliance from being misleading. In the case of material noncompliance, the auditor's report should include an other-matter paragraph describing the nature of such noncompliance. The GAS/SA Audit Guide, Paragraph 10.54, provides similar guidance.

TRANSACTIONS WITH RELATED PARTIES

Most business transactions result from bargained dealing. When the parties to a transaction are related, the objectivity expected in unrelated bargaining may be lost. Because of the loss of objectivity, knowledge of the nature and volume of transactions with related parties may be necessary for financial statement users to properly evaluate the entity's financial condition and results of operations. Consequently, FASB ASC 850-10-50, *Related Party Disclosures*, requires that material related party transactions be disclosed. In this area, an auditor's primary objective is to determine that all significant transactions with related parties have been identified (*completeness*). Once those transactions have been identified, attention focuses primarily on the adequacy of presentation and disclosure.

Members of the project owner's management and their immediate families are related parties. Related party transactions commonly encountered in HUD audit engagements that may require disclosure include partners, board members, or officers providing the project with maintenance services and general management. Some related parties are defined in the HUD regulations as "identities-of-interest." The most common identity-of-interest relationship occurs when an individual or entity with an ownership interest in the HUD-assisted entity also has an ownership interest in the management company that operates the project. If the management company has an identity-of-interest relationship with a HUD project owner, that fact must be disclosed to HUD in the "Management Entity Profile" (Form HUD-9832). A new Form HUD-9832 is required to be filed with HUD whenever there is a change in the management company, its organization, or operations.

Audit Procedures

The auditor's responsibilities concerning related parties and related party transactions are contained in AU-C 550, *Related Parties* and other related AU-C sections.

Audit procedures for related party relationships and transactions are applied at all audit stages. At the start of the audit, procedures include performing the risk assessment, identifying obvious or known related parties and transactions (or updating information obtained in previous audits) and communicating that information to the engagement team so the auditors can develop appropriate audit procedures and can recognize transactions with those parties when applying other audit procedures. Inquiry of predecessor auditors and management; discussion with the engagement team regarding the susceptibility of the financial statements to material misstatement due to error or fraud that could result from related party relationships and transactions; review of prior audit workpapers, minutes, contracts, and agreements; further audit procedures regarding the assessed risk of material misstatements associated with related party relationships and transactions; etc., are sources of information about related parties and transactions with such parties. The auditor ought to also inquire whether a new Management Entity Profile (Form HUD-9832) has been filed with HUD since the previous audit.

AU-C 550.A14 suggests the inquiries about the organization's related parties may include background information about the related parties (e.g., physical location, industry, size, and extent of operations). Known related parties should be documented, and auditors should update the list of related parties throughout the engagement and communicate changes to all engagement team members. For audits of group financial statements, communication with component auditors about related parties is required.

When examining transactions in the audit of specific accounts or in the subsequent events review, the auditor considers whether the transactions involve related parties. Generally, the same audit procedures are applied to substantiate material related-party transactions that are applied to other significant transactions. Procedures include vouching, examining authorizations, confirmation, recomputation, etc., to obtain an understanding of the transaction's nature, extent, and business purpose, and to obtain reasonable assurance that the transactions do not contain misstatements that could be material to the financial statements. The auditor could also consider arranging for audits of related-party account balances at concurrent dates, even if the fiscal years differ, and examination of specified, important, and representative related party transactions by the auditors for each of the parties, with exchange of relevant information. The auditor needs to understand that proper authorization of related-party transactions, such as by the project owner, management, board of directors, or those charged with governance, is more important than for similar transactions with unrelated parties.

Generally, the purpose of final review procedures is to evaluate whether there are undisclosed related party transactions and to evaluate the adequacy of disclosure of identified transactions. Some audit procedures, such as the overall review and final analytical procedures that are performed near the end of the audit, may disclose related party transactions. For example, those procedures can include scanning accounting records for large, unusual, or nonrecurring transactions or balances, particularly those around the end of the period; considering the nature and extent of business with major customers, suppliers, borrowers, or lenders for undisclosed relationships; and considering whether transactions are occurring, but not being given accounting recognition.

AU-C 550.18 states that when significant unusual transactions are identified, the auditor should inquire of management about the nature of the transactions and whether related parties could be involved.

FASB ASC 850 and AU-C 550.27 indicate that management's disclosures about related-party transactions should not assert that the transactions were consummated on the equivalent of an arm's length basis unless those representations can be substantiated. AU-C 550.A46 notes that generally it is difficult to substantiate management representations that a related party transaction was consummated on an arm's length basis. AU-C 550.A47-49 provides some example procedures that might be performed to substantiate such representations. If the representations cannot be substantiated, the auditor considers the implications for his opinion on the financial statements.

The auditor may wish to consider additional procedures to respond to risks relating to related party transactions and for significant related party transactions outside the normal course of business.

Related-party Transactions and Fraud. AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires the auditor to consider the existence of fraud risk factors when identifying and assessing risks of material misstatement due to fraud. A common thread in many frauds is the use of related parties unknown to the auditor to facilitate management intentionally misstating the financial statements (for example, selling real estate or other assets to a related party for artificial gain). *Equity skimming* is a specific type of fraud identified in the HUD audit guide, Paragraph 2-5, where it is defined as "the willful misuse of any part of the rent, assets, proceeds, income, or other funds derived from the project covered by the mortgage, business agreement, regulatory agreement, or other type of agreement for any purpose other than to meet actual or necessary expenses of the project." The HUD audit guide contains specific compliance audit procedures designed to detect equity skimming. A discussion about evaluating the existence of fraud is provided later in this lesson.

Previously Unidentified or Undisclosed Related Parties or Significant Related Party Transactions. AU-C 550.07 explains that because of the potential for undisclosed related party relationships and transactions, the need for planning and performing the audit with professional skepticism is particularly important. Inspection of records or documents during the audit may indicate the existence of previously unidentified or undisclosed related party relationships or transactions. AU-C 550.A23 provides the following examples of such records or documents:

- Confirmations, including bank and legal confirmations.
- Income tax returns.
- Information supplied to regulatory authorities.
- Shareholder registers or partnership ledgers.
- Conflict of interest statements from management or those charged with governance.

- Investment records of the entity.
- Agreements or contracts with those charged with governance or key management personnel.
- Significant new or renegotiated contracts or agreements outside the ordinary course of business.
- Professional advisors' correspondence or invoices.
- Financing arrangements with entities other than financial institutions.
- Capital additions through economic development arrangements by another entity.

Certain arrangements made through formal or informal agreements with one or more other parties may also be indicative of unidentified or undisclosed related party relationships or transactions. AU-C 550.A25 provides examples. The authors believe the auditor ought to seek information about the other party to such arrangements or agreements and consider the business purpose. AU-C 550.A29 also observes that a related party could be involved in a significant unusual transaction by directly or indirectly influencing it through an intermediary.

Other procedures that can be performed to identify undisclosed related parties or to investigate potential related-party transactions if the auditor decides to modify his or her procedures based on the consideration of identified fraud risks include the following:

- Review material cash disbursements, advances, and investments to consider whether the project owner provided funds to or for the benefit of a related entity.
- Discuss with tax and consulting personnel who have provided services to the client their knowledge of the client's relationships and knowledge of related parties.
- Discuss with intermediaries (such as lawyers, predecessor auditors, and others providing professional services to the client) their knowledge of the identity of principal parties to material transactions.
- Use sources of information about principal parties to material transactions (such as newspapers, industry or trade publications, the Internet, etc.) to search for information about key members of management and the company. (For example, the Internet can be used to search for corporation and limited partnership records in which a particular person's name appears.)

If the auditor's procedures identify arrangements or information that indicates the possible existence of a related party relationship or transaction that was previously unidentified or undisclosed, AU-C 550.24 requires that the auditor determine whether the underlying circumstances confirm their existence. If the auditor's procedures in fact identify such relationships or transactions, the auditor should, according to AU-C 550.25:

- Promptly communicate the information to other engagement team members.
- Have management identify all transactions with newly identified related parties.
- Inquire why controls failed to result in their identification or disclosure.
- Perform appropriate substantive procedures to the newly identified related party relationships and significant transactions.
- Reconsider the risk of other unidentified or undisclosed related party relationships or significant transactions and perform additional audit procedures as necessary.
- Evaluate the implications for other aspects of the audit if management's nondisclosure of the relationships and transactions appear intentional.

AU-C 550.A14 suggests the inquiry of the entity's related parties which may include background information (e.g., physical location, industry, size and extent of operations.)

Disclosures. FASB ASC 850-10-50 requires certain note disclosures about related parties. Although outside the scope of this course, those disclosures are summarized in *PPC's Guide to HUD Audits*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following HUD-assisted entities is exhibiting a commitment or contingency which may be of concern to a HUD auditor?

   a. Entity 1's management has consulted a lawyer to draft a contract.

   b. Entity 2 has complied with the provisions of all applicable laws and regulations.

   c. Entity 3 has a long-term lease with fixed payments for the next five years.

   d. Entity 4 has no current plans to upgrade its facilities.

8. How might commitments or contingencies related to litigation, claims, and assessments affect the audit engagement?

   a. The lawyer's response letter will have a unique date unrelated to the auditor's report.

   b. The legal representation letter should specify a materiality limit.

   c. If the client prohibits the auditor from examining certain documents, it is automatically a scope limitation.

   d. The auditor must communicate only with the client; the client will communicate with the lawyer.

9. The Clearwater HUD project has been designated as a potentially responsible party (PRP) in an environmental remediation liability. Clearwater used a specialist to estimate the liability. Harry, Clearwater's auditor, must do which of the following during the audit?

   a. Ensure that the specialist is capable, competent, and objective.

   b. Follow the guidance in the professional standards on the use of an auditor's specialist.

   c. Ensure that the entity overseeing the remediation is satisfied with the estimate.

   d. Confirm that management has obtained an understanding of the specialist's work.

10. According to AU-C 540A.A7, when might a HUD-assisted entity be required to use a fair value accounting estimate?

    a. When monetary exchanges have been made.

    b. When it acquires assets in a business combination.

    c. When it purchases new property or equipment.

    d. When it has financial instruments traded in an active market.

11. If undisclosed related party arrangements or transactions are identified, the auditor should do which of the following?

    a. Withdraw from the audit engagement immediately.

    b. Review material cash advances and disbursements to consider whether the funds benefited a related party.

    c. Communicate information about the related parties to an outside attorney.

    d. Perform substantive procedures to the identified relationships and significant transactions.

SELF STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

7. Which of the following HUD-assisted entities is exhibiting a commitment or contingency which may be of concern to a HUD auditor? **(Page 36)**

   a. Entity 1's management has consulted a lawyer to draft a contract. [This answer is incorrect. Consulting a lawyer does not always create a commitment or contingency. Entity 1 would have a commitment or contingency if it had pending or threatened litigation regardless of whether it had consulted its lawyer, but that is not the case in this scenario.]

   b. Entity 2 has complied with the provisions of all applicable laws and regulations. [This answer is incorrect. Examples of a commitment or contingency of concern to a HUD auditor include fraud and violations of laws or regulations involving management or employees that could affect HUD programs. Since Entity 2 has complied with all applicable provisions, it would not need to account for a commitment or contingency in this area.]

   c. **Entity 3 has a long-term lease with fixed payments for the next five years. [This answer is correct. Some examples of commitments and contingencies that might affect a HUD entity include long-term leases with required fixed payments for several years (like Entity 3 has in this scenario), purchase commitments, and anticipated losses on long-term contracts.]**

   d. Entity 4 has no current plans to upgrade its facilities. [This answer is incorrect. If Entity 4 had firm plans to expand or rehabilitate its facilities, those would be accounted for as a commitment. Since it does not have such plans, it is not under a commitment or a contingency in this scenario.]

8. How might commitments or contingencies related to litigation, claims, and assessments affect the audit engagement? **(Page 37)**

   a. The lawyer's response letter will have a unique date unrelated to the auditor's report. [This answer is incorrect. The letter from the client's lawyer needs to be coordinated with the date of the auditor's report. Accordingly, it is preferable for the letter to be dated to cover a period that closely corresponds to the auditor's report date, usually within two weeks of the report date.]

   b. **The legal representation letter should specify a materiality limit. [This answer is correct. The letter should specify a materiality limit so that the lawyer knows what items are to be considered material, individually or in the aggregate, for purposes of the response. The materiality amount used is generally some fraction of performance materiality. The specific amount used is a matter of auditor judgment based on knowledge of the client and other factors.]**

   c. If the client prohibits the auditor from examining certain documents, it is automatically a scope limitation. [This answer is incorrect. Because of the lawyer-client privilege, the client might identify certain documents as subject to the lawyer-client privilege and not permit the auditor to examine them. Whether this would be considered a scope limitation depends on the circumstances.]

   d. The auditor must communicate only with the client; the client will communicate with the lawyer. [This answer is incorrect. AU-C 501A.18 requires the auditor to seek direct communication with the entity's legal counsel unless the procedures performed to identify litigation, claims, and assessments do not indicate any actual or potential litigation, claims, or assessments that may give rise to a risk of material misstatement.]

9. The Clearwater HUD project has been designated as a potentially responsible party (PRP) in an environmental remediation liability. Clearwater used a specialist to estimate the liability. Harry, Clearwater's auditor, must do which of the following during the audit? **(Page 40)**

   a. **Ensure that the specialist is capable, competent, and objective. [This answer is correct. If the client (Clearwater) uses an attorney, engineer, or other specialist to make the estimate, the guidance in AU-C 500.08 on use of a management's specialist should be followed. This guidance requires the auditor to, among other things, evaluate the competence, capabilities, and objectivity of the specialist. By doing so, Harry has met one of the requirements outlined in the guidance.]**

   b. Follow the guidance in the professional standards on the use of an auditor's specialist. [This answer is incorrect. Clearwater's engineer would be considered management's specialist, not an auditor's specialist. Harry should follow the guidance in AU-C 500.08 on use of a management's specialist instead.]

   c. Ensure that the entity overseeing the remediation is satisfied with the estimate. [This answer is incorrect. Per AU-C 500.08, the auditor is required to evaluate the appropriateness of the specialist's work as audit evidence for the relevant assertion. Therefore, if Harry merely ensures that the overseeing entity is satisfied with the specialist's work estimating the amount, he will not have done enough to meet the requirements of this guidance.]

   d. Confirm that management has obtained an understanding of the specialist's work. [This answer is incorrect. Harry himself, not management, is required to obtain an understanding of the specialist's work. Management's understanding is not enough to meet the requirements in AU-C 500.08.]

10. According to AU-C 540A.A7, when might a HUD-assisted entity be required to use a fair value accounting estimate? **(Page 43)**

    a. When monetary exchanges have been made. [This answer is incorrect. If the HUD-assisted entity makes monetary exchanges, no fair value accounting estimate would be needed since the fair value would be the amount of the money exchanged. On the other hand, if certain *nonmonetary* exchanges are made, the entity would likely need to use a fair value accounting estimate.]

    b. **When it acquires assets in a business combination. [This answer is correct. One example provided in AU-C 540A.A7 of a circumstance in which fair value accounting estimates may be required is when certain assets or liabilities are acquired in a business combination.]**

    c. When it purchases new property or equipment. [This answer is incorrect. Use of a fair value accounting estimate may be needed when property or equipment is held for disposal, not at the time it is purchased new.]

    d. When it has financial instruments traded in an active market. [This answer is incorrect. A fair value accounting estimate may be needed for complex financial instruments that are *not* traded in an active and open market.]

11. If undisclosed related party arrangements or transactions are identified, the auditor should do which of the following? **(Page 50)**

    a. Withdraw from the audit engagement immediately. [This answer is incorrect. Per AU-C 550.25, the auditor should reconsider risk of other unidentified or undisclosed related party relationships and perform additional procedures. Withdrawing from the engagement may not be necessary.]

    b. Review material cash advances and disbursements to consider whether the funds benefited a related party. [This answer is incorrect. This procedure can be performed to identify undisclosed related parties or to investigate potential related-party transactions. This is not one of the procedures listed in AU-C 550.25 when undisclosed arrangements or transactions are identified.]

c. Communicate information about the related parties to an outside attorney. [This answer is incorrect. According to AU-C 550.25, the auditor must promptly communicate the information to other engagement team members, not an attorney. The auditor should have management identify all transactions with the newly identified related parties.]

d. **Perform substantive procedures to the identified relationships and significant transactions. [This answer is correct. If the auditor's procedures identify arrangements or information that indicates the possible existence of a related party relationship or transaction that was previously unidentified or undisclosed, AU-C 550.24 requires that the auditor determine whether the underlying circumstances confirm their existence. If the auditor's procedures in fact identify such relationships or transactions, AU-C 550.25 outlines actions the auditors should take. Those actions include, among other things, performing appropriate substantive procedures to the newly identified related party relationships and significant transactions.]**

GUIDANCE FOR GOING CONCERN CONSIDERATIONS

Introduction and Authoritative Literature

FASB ASC 205-40, *Presentation of Financial Statements—Going Concern*, provides guidance about management's responsibility to evaluate whether there is substantial doubt about an entity's ability to continue as a going concern and to provide related disclosures. The key features of FASB ASC 205-40 are as follows:

- Defines the term *substantial doubt*.
- Requires management to evaluate whether conditions and events raise substantial doubt at both interim and annual period ends.
- Requires management's evaluation to be based on an assessment of the effect of known and reasonably knowable conditions and events at the date the financial statements are available to be issued for a period one year after that date.
- Identifies principles for considering whether management's plans mitigate the substantial doubt.
- Requires certain disclosures when consideration of management's plans alleviates substantial doubt.
- Requires an explicit statement by management that there is substantial doubt as well as other disclosures when substantial doubt is not alleviated.

AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, explicitly recognizes management's responsibility to consider going concern issues under GAAP and premises the auditor's procedures on that responsibility. It also clarifies the applicability of the standard when the financial statements are based on a financial reporting framework other than GAAP.

COVID-19 Going Concern Considerations

The authors recommend that practitioners review factors related to the COVID-19 pandemic when performing procedures related to management's going concern evaluation and the auditor's assessment of management's plans. The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to respond to any COVID-19 related audit issues. The AICPA has, however, provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the accounting and auditing issues created.

Objectives and Requirements

The auditor's objectives under AU-C 570 are as follows:

- To obtain sufficient and appropriate audit evidence about and conclude on the appropriateness of management's use of the going concern basis of accounting in preparing the financial statements.
- To conclude on whether substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time exists, based on the audit evidence obtained.
- To evaluate possible effects on the financial statements, such as the adequacy of disclosure regarding an entity's ability to continue as a going concern for a reasonable period of time.
- To issue an auditor's report in accordance with the auditing standard.

AU-C 570 defines *reasonable period of time* as the period required by the applicable financial reporting framework, or, if no such period is designated, one year from the date the financial statements are available to be issued. This brings the lookout period under the auditing standards into line with the period defined by GAAP in FASB ASC 205-40.

Risk Assessment Procedures and Related Activities

AU-C 570 was modeled by the AICPA after the IAASB's International Standard for Auditing, which includes going concern procedures early in the audit process. AU-C 570 includes procedures for auditors to perform in the planning and risk assessment phases of the audit. AU-C 570.12 requires that the auditor consider, when performing risk assessment procedures as discussed in AU-C 315A, whether there are aggregate conditions or events that raise doubt about the entity's ability to continue as a going concern for a reasonable period of time. As part of risk assessment procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events have been identified. If so, auditors and management discuss management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, as well as plans to address any issues identified. If management has not yet made such an evaluation, the auditor has to discuss with management why management intends to use the going concern basis and inquire as to any existing conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. Auditors should consider management's evaluation in the risk assessment process and remain alert throughout the audit for any evidence indicating conditions or events that raise substantial doubt regarding going concern.

Outside of the requirements for inquiry and discussion with management regarding its evaluation of aggregate conditions or events, AU-C 570 does not specify any other specific risk assessment procedures designed to search for conditions or events that might affect the entity's ability to continue as a going concern.

AU-C 570.A7 notes, similar to FASB ASC 205-40, that an entity should determine the likelihood and magnitude of the potential effects of conditions and events that can raise substantial doubt about an entity's ability to continue as a going concern, along with the consideration of the timing. AU-C 570.A7 provides the following examples of such conditions or events:

a. Negative trends, such as recurring operating losses, working capital deficiencies, negative cash flows from operating activities, or adverse key financial ratios.

b. Other indications of possible financial difficulties, such as default on loans or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, need to seek new sources or methods of financing, or need to dispose of substantial assets.

c. Internal matters, such as work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, need to significantly revise operations.

d. External matters that have occurred, such as adverse legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; or uninsured or underinsured catastrophe (such as drought, earthquake, or flood).

Owners of HUD-assisted projects are often sensitive to the economic environment and conditions in the multifamily housing market. Auditors need to consider whether economic or other recent developments may affect the project owner's operations. Matters that could affect the financial statements include demographic changes, local housing trends, societal attitudes, tax laws or rate changes, inflation, interest rates, rental rates, significant deferred maintenance, and changes in government funding policies. An owner's inability to amend a HAP contract that is producing insufficient rent levels may, in some cases, create substantial doubt about a project owner's ability to continue as a going concern.

Auditors need to also be aware of any financial covenants in legal or regulatory agreements. For example, a HUD insured loan or other agreement might require the entity to maintain a minimum debt to equity ratio. In that case, the auditor ought to be aware of the sensitivity of those ratios and the fact that management might be motivated to manipulate the financial statement amounts underlying them. Analytical procedures should be developed using independent data or data that is more difficult to manipulate. For example, analytical procedures relating to rental revenue might include comparisons to prevailing market rental and occupancy rates.

The Auditor's Evaluation

AU-C 570 requires the auditor's evaluation to address management's evaluation of the entity's ability to continue as a going concern, consider the same time period as management's evaluation, and consider whether management has considered all relevant information of which the auditor is aware when making management's evaluation. The auditor's evaluation of management's evaluation of whether there is substantial doubt might include a review of the process that management used, the assumptions employed, management's plans, and whether the plans are feasible in the circumstances.

Periods beyond the Evaluation Period

AU-C 570.15 notes that the auditor should inquire if management has any knowledge of conditions or events beyond the management evaluation period that could affect the entity's ability to continue as a going concern. Besides that inquiry, no additional procedures are required for the identification of additional conditions or events that may raise substantial about the entity's ability to continue as a going concern beyond the period evaluated by management. AU-C 570.A27 notes that knowledge of conditions or events beyond the one-year evaluation period would not affect the evaluation of whether substantial doubt exists, but may affect other disclosure requirements or a consideration of whether financial statements are fairly presented.

Audit Procedures

To obtain sufficient appropriate audit evidence about whether conditions and events identified and considered in the aggregate raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time, AU-C 570.16 states that the auditor should perform the following procedures:

- Request that management perform an evaluation if they have not yet done so.
- Evaluate management's plans in relation to its going concern evaluation, considering whether it is probable that the plans can be effectively implemented, and whether the plans would mitigate the conditions or events that raise substantial doubt about the entity's ability to continue as a going concern.
- If a cash forecast relevant to management's plans has been prepared, evaluate the reliability of the underlying data generated to prepare it and determine whether there is adequate support for the underlying assumptions. This includes considering contradictory audit evidence, such as assumptions in the cash flow forecasts that are inconsistent with those used for other purposes like impairment or deferred tax asset analysis.
- Consider any facts or information that have become available since the date of management's evaluation.

Other Relevant Procedures. AU-C 570.A28 provides examples of procedures that might be relevant to obtaining sufficient appropriate audit evidence whether identified conditions or events raise substantial doubt about the entity's ability to continue as a going concern, as follows:

- Analyze and discuss with management relevant forecasts, such as cash flow, profit, or others.
- Analyze and discuss the most recently available interim financial statements.
- Read debenture and loan agreements and determine whether any terms have been breached.
- Read minutes of meetings of those charged with governance and relevant committees, to identify indications of financial difficulties.
- Inquire of legal counsel about litigation and claims and the reasonableness of management's evaluation of the outcome and estimates.
- Confirm with lenders the existence and terms of borrowing facilities and evaluate their adequacy.
- Obtain and review reports of regulatory actions.
- Obtain support for any planned disposals of assets and determine its adequacy.

Management's Plans. The significance of identified conditions or events may be mitigated by certain plans of management that are probable of implementation and would be effective in overcoming the adverse effects of such conditions or events. AU-C 570.A8 provides examples of management plans that might be implemented and the information that should be considered when evaluating the plan's feasibility and probability of effective implementation within one year after the date the financial statements are available to be issued.

Auditor's Conclusions

AU-C 570 requires the auditor to make the following conclusions:

- Evaluate whether sufficient appropriate audit evidence has been obtained and conclude on the appropriateness of management's use of the going concern basis of accounting, when preparing the financial statements, when relevant.
- Conclude, based on audit evidence obtained, on whether there are aggregate conditions or events that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time.
- When the auditor concludes that the use of the going concern basis of accounting is appropriate by management, but substantial doubt about the ability to continue as going concern exists, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.
- When aggregate conditions or events have been identified and, based on audit evidence obtained, the auditor concludes that substantial doubt about the entity's ability to continue as a going concern has been alleviated, evaluate the adequacy of the disclosures as required by the applicable financial reporting framework.

When considering the adequacy of the disclosures under U.S. GAAP, the auditor will look to the requirements in FASB ASC 205-40-50. Guidance for reporting under AU-C 570 is provided in *PPC's Guide to Auditor's Reports*.

Management's Representations

AU-C 570.18 requires the auditor to obtain written representations from management if conditions and events indicate there is substantial doubt about the entity's ability to continue as a going concern. Representations are required even if the auditor concludes, based on evaluation of management's plans, that substantial doubt is alleviated.

Communicating with Those Charged with Governance

AU-C 570.28 requires certain communications with those charged with governance unless all are involved in managing the entity. *PPC's Guide to HUD Audits* includes the matters that should be communicated.

Documentation Requirements

When conditions or events cause the auditor to believe there is substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time before the consideration of management plans, AU-C 570.32 requires documentation of the following:

- The conditions or events.
- Significant elements of management's plans to overcoming the conditions or events, per the auditor's judgment.
- Audit procedures performed in evaluating significant elements of management's plans and the evidence obtained, where applicable.
- The auditor's conclusion regarding whether substantial doubt continues to exist or is alleviated.
- When substantial doubt remains, the possible effects of the conditions or events on the financial statements and the adequacy of disclosures.

- When substantial doubt is alleviated, the auditor's conclusion about the need for and the adequacy of disclosures about the principal conditions or events that originally created substantial doubt and management's plans that alleviated it.
- The auditor's conclusion concerning the effects of the auditor's report.

The authors recommend that at a minimum, auditors use a generalized audit program step or checklist to document going concern considerations. This will ensure that the assessment will be made on every audit.

OBTAINING WRITTEN REPRESENTATIONS

AU-C 580.09, *Written Representations*, requires the auditor to request written representations from management with appropriate responsibilities for the financial statements. Among other things, AU-C 580.10–.11 requires the auditor to request management to provide specific representations that it has fulfilled the responsibilities concerning the terms of the audit engagement for:

- Preparation and fair presentation of the financial statements.
- Design, implementation, and maintenance of internal control relevant to preparation and presentation of financial statements that are free of material misstatements due to error or fraud.
- Providing all relevant information and access.
- Recording and reflecting all transactions in the financial statements.

AU-C 580 and other auditing and professional standards applicable in a HUD audit require the auditor to request other written representations from management. In addition, the auditor may request other written representations that he or she considers appropriate to support other audit evidence or specific assertions in the financial statements in certain situations.

AU-C 580.25 indicates that with respect to the representations required by AU-C 580.10–.11 if (a) management does not provide them, or (b) the auditor concludes that sufficient doubt exists about management integrity that these representations are not reliable, then the auditor is required to disclaim an opinion in accordance with AU-C 705, *Modifications to the Opinion in the Independent Auditor's Report*, or withdraw from the engagement.

AU-C 580 and other auditing standards require the auditor to request other written representations from management. In addition, the auditor may request other written representations that he or she considers appropriate in certain situations. AU-C 580.12–.18 requires the auditor to request management to provide specific written representations related to the following matters:

- Fraud.
- Laws and regulations.
- Uncorrected misstatements.
- Litigation and claims.
- Estimates.
- Related party transactions.
- Subsequent events.

AU-C 580.26 indicates that when management does not provide one or more of the other written representations requested, the auditor should (a) discuss the omission with management, (b) reevaluate management's integrity, (c) evaluate the implications for the reliability of management's other written or oral representations and audit evidence generally, and (d) take appropriate actions. Appropriate actions include determining the possible effect on the auditor's report pursuant to the guidance provided by AU-C 705.

With respect to these other specific representations required by AU-C 580.12–.18, representations required by other AU-C sections or any additional representations, the auditor believes necessary in the circumstances, management's refusal to provide them is a scope limitation, and is often sufficient to preclude an unmodified opinion. Specifically with respect to the representations identified in AU-C 580.12–.18, management's refusal may cause the auditor to withdraw or disclaim an opinion. AU-C 580.A34, however, explains that, depending on the nature of the representations not obtained or the circumstances of the refusal, a qualified opinion rather than a disclaimer may be appropriate. For the written representations required by AU-C 580.10–.11, as explained above, a disclaimer or withdrawal is always required.

Project owners frequently use management agents; consequently, there is often a great deal of auditor interaction with management agent personnel and less interaction with persons charged with the governance of the owner of the HUD project. In those circumstances, it is particularly important to remind management and the officers of the project owner of their responsibility for the financial statements and compliance with HUD program requirements. Discussing the content of the representation letter with the parties can help. Some auditors require the management agent to sign the representation letter. The representation letter emphasizes to the appropriate parties their responsibility to provide the auditors with complete and accurate information.

Content of the Letter

While a management representation letter is usually prepared by an auditor, it is a communication from the client to the auditor and is signed by client management. The representation letter acknowledges management's primary responsibility for the financial statements, even if the auditor drafts or assists with drafting the financial statements and related notes. Additionally, as discussed later in this section, the representations obtained from management provide other audit evidence and support the validity of results of audit procedures performed.

In the representation letter, client officials acknowledge their primary responsibility for the financial statements and for compliance with HUD program requirements. The representations also provide other audit evidence and support the validity of results of audit procedures performed. AU-C 580.10–.18 provides a list of specific representations that should be obtained. The letter should include any other matters relevant to HUD entities or to the specific engagement. In a HUD audit, such matters related to financial statement amounts might include representations about the validity and valuation of receivables, related party transactions, and restrictions on cash.

Representations Required by the HUD Audit Guide

The HUD Audit Guide, Paragraph 1-5(D), requires the auditor of for-profit HUD entities to obtain written representations about matters related to (a) compliance with program laws and regulations that have a material effect on the financial statements and each HUD-assisted program, (b) all compliance violations or issues, regardless of their materiality, and (c) management's responsibilities to establish and maintain effective control over financial reporting and internal control over compliance.

Uncorrected Misstatements

AU-C 580.14 requires an acknowledgment in the representation letter that management has considered whether the effects of uncorrected misstatements are immaterial, both individually and in the aggregate, to the financial statements. A summary of the uncorrected misstatements should be included in, or attached to, the representation letter.

Auditors can use practice aids such as those provided in *PPC's Guide to HUD Audits* to draft a summary and evaluation of audit differences. Other approaches for complying with the requirements of AU-C 580.14 also are acceptable, such as summarizing the uncorrected misstatements within the body of management's representation about uncorrected misstatements. However, this approach may entail a greater degree of summarization than would be presented in a separate schedule.

The auditor should request management to correct misstatements accumulated during the audit, except for those that are clearly trivial. Even so, management may have reasons for refusing to correct some (or all) misstatements. In some circumstances, management may not believe that certain uncorrected misstatements are misstatements. In that situation, management may want to add wording to the representation letter such as, "We do not agree that items . . . constitute misstatements because [description of reasons].” Obtaining such a representation does not relieve the auditor from forming a conclusion about the effect of uncorrected misstatements pursuant to AU-C 450, *Evaluation of Misstatements Identified During the Audit*. Nevertheless, compliance with AU-C 580 certainly is simplified if management records all audit adjustments. In many cases, especially for smaller entities that rely on the auditor for accounting knowledge, management will agree to record all audit adjustments.

The communication of uncorrected misstatements in the representation letter does not constitute a communication to management (or those charged with governance) under AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, or AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*. That guidance addresses the different communication responsibilities discussed later in this lesson. The auditor considers the client's decision to not record audit adjustments when identifying and assessing fraud risks, but the decision to not record all proposed adjustments does not necessarily mean the client is intentionally misstating the financial statements.

Materiality

AU-C 580 permits, but does not require, limiting representations to matters that are either individually or collectively material to the financial statements. AU-C 580.A22 explains that limitation is acceptable for representations that directly relate to amounts included in the financial statements if the auditor and management reach an agreement about what is material for this purpose. It would not be acceptable to limit representations about the completeness of available financial records, management's responsibility for fair presentation, or management's acknowledgment of its responsibility for the design, implementation, and maintenance of internal control to prevent and detect fraud. AU-C 580.A22 notes that materiality may be different for different representations, and indicates that an explicit discussion of materiality may be in the representation letter, in either qualitative or quantitative terms. A discussion that includes both qualitative and quantitative terms is also acceptable, but the authors discourage using a purely quantitative discussion of materiality because it is inappropriate to rely solely on quantitative considerations when determining materiality.

The authors do not believe the quantitative approach discussed in the previous paragraph is practical with respect to HUD programs for a HUD audit. In those instances, the discussion should be tailored to reflect the requirements of the HUD audit guide; or in the case of a Single Audit of a nonprofit HUD entity, the Uniform Guidance.

Representations Related to Supplementary Information

HUD entities are required to submit their annual financial report to HUD electronically through FASSUB. The financial data is submitted using templates that require using the HUD-prescribed chart of accounts. Additional schedules, such as a schedule of residual receipts, are also required. A hard copy of the financial report and schedules submitted to HUD through FASSUB is presented with the audited financial statements as supplementary information. AU-C 725, *Supplementary Information in Relation to the Financial Statements as a Whole*, requires the auditor to obtain specific representations in order to provide an opinion on whether information accompanying the financial statements is fairly presented, in all material respects, in relation to the financial statements as a whole. Thus, in a HUD audit, the auditor should obtain the following additional representations identified at AU-C 725.07:

- Management is responsible for presenting the supplementary information in accordance with HUD's *Uniform Financial Reporting Standards for HUD Housing Programs*.
- Management believes the supplementary information, including its form and content, is fairly presented in accordance with HUD's *Uniform Financial Reporting Standards for HUD Housing Programs*.
- The methods of measurement or presentation have not changed from those used in the prior period or, if the methods of measurement or presentation have changed, the reasons for such changes.
- Management has disclosed to the auditor information about any significant assumptions or interpretations underlying the measurement or presentation of the supplementary information.
- If the supplementary information is not presented with the audited financial statements, management will make the audited financial statements readily available to the intended users of the supplementary

information no later than the date the entity issues the supplementary information and the related auditor's report.

While the representations listed in the preceding paragraph are discussed in the context of the supplementary information required by HUD, the representations presented at AU-C 725.07 are required in relation to *any* supplementary information that accompanies the financial statements when the auditor is engaged to provide an opinion on whether such information is fairly presented in relation to the financial statements as a whole. Thus, the additional representations are required if the auditor is engaged to report on supplementary information such as a detailed schedule of revenues and expenses compared to budget. If the auditor is engaged to audit a nonprofit HUD-assisted entity, the representations required by AU-C 725.07 should be obtained with respect to both the supplementary information required by HUD and the schedule of expenditures of federal awards required by the Uniform Guidance.

Representations Related to *Government Auditing Standards*

Paragraph 3.61 of the GAS/SA Audit Guide indicates that, with respect to the financial statement audit performed under GAAS and the Yellow Book, it might be appropriate for auditors to obtain additional representations acknowledging matters such as management's responsibilities for compliance with the laws, regulations, and provisions of contracts and grant agreements that are applicable to the entity.

Representations Related to Compliance Audit Procedures

The auditor should obtain the written representations required by AU-C 935, *Compliance Audits*, with respect to the compliance audit procedures performed in a HUD audit. The specific representations listed at AU-C 935.23 include the following:

- Management's acknowledgment of its responsibility for understanding and complying with applicable compliance requirements.
- Management's acknowledgment of its responsibility for establishing and maintaining controls that provide reasonable assurance government programs are administered in accordance with the compliance requirements.
- A statement that management has identified and disclosed to the auditor all of the entity's government programs and related activities subject to the governmental audit requirement.
- A statement that management has made available to the auditor all contracts and grant agreements, related amendments, and any other correspondence relevant to the programs and activities subject to the governmental audit requirement.
- A statement that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements, or that there was no such noncompliance.
- Management's belief that the entity has complied with the applicable compliance requirements (except for noncompliance that was disclosed to the auditor).
- A statement that management has made available to the auditor all documentation related to compliance with the applicable compliance requirements.
- Management's interpretation of any applicable compliance requirements that are subject to varying interpretations.
- A statement that management has disclosed to the auditor any communications from grantors and pass-through entities regarding possible noncompliance with the applicable compliance requirements, including communications received up to the date of the auditor's report.
- A statement that management has disclosed to the auditor the findings received and related corrective actions taken for previous audits, attestation engagements, and internal or external monitoring that directly

relate to the objectives of the compliance audit, including findings received and corrective actions taken up to the date of the auditor's report.

- A statement that management has disclosed to the auditor all known noncompliance with the applicable compliance requirements subsequent to the period covered by the auditor's report or that there were no such known instances.
- Management's acknowledgement that it is responsible for taking corrective action on audit findings of the compliance audit.

The auditor also should request additional representations about compliance with applicable compliance requirements that he or she considers necessary, as discussed in the next paragraph.

The GAS/SA Audit Guide, at Paragraph 10.78, suggests additional representations. Some of the representations that may be applicable in the compliance portion of a HUD audit are as follows:

- Management is responsible for and has accurately prepared the (a) summary schedule of prior audit findings to include all findings required to be included by the applicable guidance (that is, the HUD audit guide, or the Uniform Guidance for Single Audits of nonprofit entities) and (b) a corrective action plan for current year audit findings that meets the requirements of the applicable guidance.
- If applicable, management has disclosed all contracts or other agreements with service organizations.
- If applicable, management has disclosed to the auditor all communications from service organizations relating to noncompliance at those organizations.
- For audits of nonprofit HUD-assisted entities, no protected personally identifiable information is included in the reporting package.
- For audits of nonprofit HUD-assisted entities, management has accurately completed the appropriate sections of the data collection form.

Oral Communications

If required communications are orally reported (as permitted in certain circumstances under AU-C 260), it is desirable for management to acknowledge in the representation letter that the matters have been reported.

Signatures and Dating and Updating of the Letter

AU-C 580.09 requires the auditor to request written representations from management with knowledge of the matters covered and with appropriate responsibilities for the financial statements. AU-C 580.A2 indicates that the appropriate individuals from whom to make the request depends on governance structure. The management representation letter generally should be signed by (a) the project owner's current CEO; for example, the managing partner, president, or director of the nonprofit organization; (b) the current controller or treasurer; and (c) if applicable, the current management agent. A common qualifying phrase that is used in written representations is that they are being made "to the best of management's knowledge and belief." AU-C 580.A6 indicates that the auditor may accept this qualifying language if the auditor is able to conclude that the parties making them have appropriate knowledge and appropriate responsibilities concerning the matters included in the representations.

The auditor is concerned with matters occurring through the date of his or her report, not merely through the balance sheet date. As a result, the management representation letter should be dated as of the date of the auditor's report. A discussion on dating the auditor's report appears later in this lesson. The date of management's subsequent events review was discussed earlier.

There are circumstances that require predecessor auditors to obtain updating representation letters from management. AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, requires a predecessor auditor to obtain a representation letter from management, as well as a representation letter from the successor auditor, before reissuing a report on financial statements of a prior period. This requirement applies when the prior period financial statements are presented on a comparative basis with audited financial statements of a subsequent period. The updating management representation letter should address (a) whether management is aware of any new information that would cause them to believe that any of the previous representations should be modified, and (b) whether any events occurring subsequent to the latest balance sheet date of the financial statements reported on by the predecessor require disclosure in or adjustment to such financial statements.

Periods Covered by the Letter

AU-C 580.20 requires written representations from management who has responsibility for the financial statements and knowledge of the matters concerned for all financial statements and periods covered in the auditor's report. AU-C 580.A26 explains that even when current management was not present during all periods referred to in the auditor's report, current management's responsibilities for the financial statements as a whole are not diminished and the requirement for the auditor to request from them written representations that cover all the relevant periods still applies. For example, if the auditor's report covers the financial statements for the years ended 20X1 and 20X2, management's representation letter should also cover both years. If management changed during or after the period under audit, the auditor still has to insist on written representations from current management.

An AICPA Question and Answer (Q&A 8900.11), *Management Representations Regarding Prior Periods Presented That were Audited by a Predecessor Auditor*, clarifies that the successor auditor does not have to obtain management representations covering the prior period financial statements when: (a) the prior period financial statements were audited by a predecessor auditor, (b) the predecessor auditor's report on the prior period's financial statements is not reissued, and (c) and the successor auditor will not opine on the prior period's financial statements (that is, the successor auditor's report will express an opinion on the current period's financial statements and include an other-matter paragraph regarding the predecessor auditor as required by AU-C 700.55). In that case, the representations are not needed for the prior period because the successor auditor is not opining on the prior period's financial statements. Further representations may be necessary in the current year; however, if the successor auditor finds material misstatements in the prior period's financial statements, and the successor auditor audits the restatement adjustments. Also, a successor auditor may request current period written representations related to opening balances, such as prior period internal control deficiencies, consistency in accounting policies, and matters related to report modifications.

Receipt of the Letter

AU-C 580.A27 indicates that the auditor does not need to physically possess management's representation letter on the date of the auditor's report. The requirement can be met if on or before the date of the auditor's report management has received the final representation letter and confirmed to the auditor that they will sign the letter without exception. The auditor will need to physically possess the signed letter before releasing the audit report. Management's refusal to furnish written representations constitutes a limitation on the scope of the audit often sufficient to preclude an unmodified opinion and may cause an auditor to disclaim or withdraw.

Written Representations as Audit Evidence

Written representations provide audit evidence, but according to AU-C 580.03–.04, do not on their own provide sufficient appropriate evidence about the matters dealt with in the representations. Obtaining reliable written representations is necessary to express an opinion, but does not affect the nature, timing, or extent of procedures the auditor applies to obtain evidence about management's fulfillment of its responsibilities or about specific financial statement assertions. This restraint on reliance on written representations even applies to matters of management intent and judgment. AU-C 580.A21 explains that the auditor may consider it necessary to obtain written representations to support the auditor's understanding obtained from other audit evidence about management's judgment or intent regarding, or the completeness of, a specific assertion. Management's intent, for example, may be important to the valuation of certain investments. Written representations provide necessary evidence in these circumstances, but do not on their own provide sufficient appropriate evidence. AU-C 580.A20 explains that when obtaining evidence about judgments and intentions of management, the auditor may consider one or more of the following:

- Prior history of carrying out intentions.
- Reasons for taking a particular course of action.

- Ability to follow a specific course of action.
- Information, or lack thereof, obtained during the audit that may be inconsistent with judgements or intentions of management.

Thus, even in the case of matters such as management's judgments and intentions, the auditor cannot rely solely on written representations.

Form of Written Representations. AU-C 580.21 specifically requires that written representations be obtained in the form of a representation letter addressed to the auditor. Exhibit A to AU-C 580 provides an illustrative example of a representation letter.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

12. Which of the following could give rise to doubt about an entity's ability to continue as a going concern?

    a. Favorable resolution of a legal proceeding.

    b. A work stoppage.

    c. Paying off a loan earlier than planned.

    d. One period of operating losses.

13. If there is substantial doubt about an entity's ability to continue as a going concern, all of the following matters require documentation **except**:

    a. Management representations concerning their responsibilities for the financial statements.

    b. The conditions or events leading to the doubt.

    c. What management plans to do to mitigate the problems.

    d. The auditor's conclusion about whether significant doubt still exists.

14. Which of the following statements best describes the written representations needed for an audit engagement?

    a. No specific representations are needed from management to meet the requirements of a HUD audit engagement.

    b. If management refuses to provide certain written representations, the auditor may need to withdraw from the engagement.

    c. The representation letter should confirm that no information was communicated orally because written communications are required.

    d. Because a management representation letter is generally prepared by the auditor, the auditor needs to sign it.

15. Which of the following additional representations would be most applicable in the compliance portion of a HUD audit?

    a. The auditor is responsible for and has accurately prepared a corrective action plan for the current year audit findings.

    b. If the audit is for a nonprofit, all relevant personally identifiable information is included in the package.

    c. Management has disclosed all contracts or other agreements with service organizations.

    d. If the audit is for a nonprofit, the auditor has completed the appropriate sections of the data collection form.

SELF STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

12. Which of the following could give rise to doubt about an entity's ability to continue as a going concern? **(Page 56)**

    a. Favorable resolution of a legal proceeding. [This answer is incorrect. External occurrences that could indicate difficulties continuing as a going concern include adverse legal proceedings, legislation, or similar matters that might jeopardize the entity's ability to operate; loss of a key franchise, license, or patent; loss of a principal customer or supplier; or an uninsured/underinsured catastrophe. If a legal proceeding is resolved in favor of the entity, it is more likely to be able to continue as a going concern.]

    b. **A work stoppage. [This answer is correct. As noted in AU-C 570.A7, internal matters that may indicate doubt about continuing as a going concern include work stoppages or other labor difficulties, substantial dependence on the success of a particular project, uneconomic long-term commitments, or the need to significantly revise operations.]**

    c. Paying off a loan earlier than planned. [This answer is incorrect. Doubt may arise about an entity's ability to continue as a going concern if there are indications of possible financial difficulties, such as defaults on loans or similar agreements, arrearages in dividends, denial of usual trade credit from suppliers, restructuring of debt, the need to seek new sources or methods of financing, or the need to dispose of substantial assets. Paying off a loan early would typically indicate a positive financial situation and the ability to continue as a going concern.]

    d. One period of operating losses. [This answer is incorrect. Negative trends, such as recurring operating losses, working capital deficiencies, negative cash flows from operating activities, or adverse key financial ratios, are more likely to indicate a going concern issue. One operating loss would not necessarily indicate a going concern problem.]

13. If there is substantial doubt about an entity's ability to continue as a going concern, all of the following matters require documentation **except**: **(Page 58)**

    a. **Management representations concerning their responsibilities for the financial statements. [This answer is correct. The requirement that the auditor request written representations from management with appropriate responsibilities for the financial statements is *not* one of the matters required to be documented related to going concern.]**

    b. The conditions or events leading to the doubt. [This answer is incorrect. AU-C 570.32 requires documentation of certain specific matters when the auditor believes there is substantial doubt about an entity's ability to continue as a going concern. One of those matters is documentation of the associated conditions or events that led to the doubt.]

    c. What management plans to do to mitigate the problems. [This answer is incorrect. As listed in AU-C 570.32, one of the matters requiring documentation when there are going concern doubts is the significant elements of management's plans to overcoming the conditions or events, per the auditor's judgment.]

    d. The auditor's conclusion about whether significant doubt still exists. [This answer is incorrect. Per AU-C 570.32, if there is doubt about an entity's ability to continue as a going concern, the auditor's conclusion regarding whether substantial doubt continues to exist or is alleviated is required to be documented.]

14. Which of the following statements best describes the written representations needed for an audit engagement? **(Page 59)**

    a. No specific representations are needed from management to meet the requirements of a HUD audit engagement. [This answer is incorrect. AU-C 580.10–.11 requires several specific representations from management, while AU-C 580 and other auditing and professional standards applicable in a HUD audit require the auditor to request other written representations from management, as well. In addition, the auditor may request other written representations that he or she considers appropriate to support other audit evidence or specific assertions in the financial statements in certain situations.]

b. **If management refuses to provide certain written representations, the auditor may need to withdraw from the engagement. [This answer is correct. AU-C 580.25 indicates that with respect to the representations required by AU-C 580.10–.11, if (1) management does not provide them, or (2) the auditor concludes that sufficient doubt exists about management integrity that these representations are not reliable, then the auditor is required to disclaim an opinion, or withdraw from the engagement.]**

c. The representation letter should confirm that no information was communicated orally because written communications are required. [This answer is incorrect. If required communications are orally reported (as permitted in certain circumstances under AU-C 260), it is desirable for management to acknowledge in the representation letter that matters have been reported.]

d. Because a management representation letter is generally prepared by the auditor, the auditor needs to sign it. [This answer is incorrect. While a management representation letter is usually prepared by an auditor, it is a communication from the client to the auditor and is signed by client management. It would not be appropriate for the auditor to sign it, even if the auditor drafts or assists with drafting the financial statements and related notes.]

15. Which of the following additional representations would be most applicable in the compliance portion of a HUD audit? **(Page 63)**

a. The auditor is responsible for and has accurately prepared a corrective action plan for the current year audit findings. [This answer is incorrect. Per the GAS/SA Audit Guide, in the compliance portion of a HUD audit it may be applicable for management (not the auditor) to represent that it is responsible for and has accurately prepared the (1) summary schedule of prior audit findings to include all findings required to be included by the applicable guidance, and (2) a corrective action plan for current year audit findings that meets the requirements of the applicable guidance.]

b. If the audit is for a nonprofit, all relevant personally identifiable information is included in the package. [This answer is incorrect. According to the GAS/SA Audit Guide, one representation that may be applicable in the compliance portion of a HUD audit is that for audits of nonprofit HUD-assisted entities, *no* protected personally identifiable information is included in the reporting package.]

c. **Management has disclosed all contracts or other agreements with service organizations. [This answer is correct. The GAS/SA Audit Guide, at Paragraph 10.78, suggests additional representations that may be applicable in the compliance portion of a HUD audit. Examples include, if applicable, that management has disclosed all contracts or other agreements with service organizations, and that management has disclosed to the auditor all communications from service organizations relating to noncompliance at those organizations.]**

d. If the audit is for a nonprofit, the auditor has completed the appropriate sections of the data collection form. [This answer is incorrect. The GAS/SA Audit Guide suggests that one additional representation for audits of nonprofit HUD-assisted entities is that management (not the auditor) has accurately completed the appropriate sections of the data collection form.]

THE ACCUMULATED RESULTS OF AUDIT PROCEDURES

Reevaluating Risk Assessments and Evaluating Audit Evidence

The auditor's assessment of the risks of material misstatement at the relevant assertion level made during planning is based on available audit evidence and naturally may change as additional evidence is obtained. For example, in performing substantive procedures for the financial statement audit, the auditor may identify misstatements that are larger or more frequent than had been anticipated. AU-C 315A.32 requires the auditor to revise the risk assessment and modify further planned audit procedures if new information is obtained or if the initial assessed risks of material misstatement at the assertion level changes during the audit. Furthermore, AU-C 330.27 requires the auditor to reevaluate, before the conclusion of the audit, whether the assessment of risks of material misstatement at the relevant assertion level remains appropriate. The audit evidence may either confirm the auditor's risk assessments or result in the auditor performing additional audit procedures. Exhibit 2-1 illustrates this concept.

Exhibit 2-1

Reevaluating the Initial Assessment of the Risk of Material Misstatement at the Relevant Assertion Level

When planning the audit of ABC HUD Project, the auditor initially assessed a low level of risk that the HUD entity would not record rental receipts in the proper period. The auditor then determined the nature, timing, and extent of substantive procedures related to the cut-off assertion based on her assessment of a relatively low risk of material misstatement. However, the accounting personnel were confused about how to record post-dated rent checks that had not been deposited by December 31.

The auditor sent confirmations to a sample of tenants. Confirmation results indicated a likely misstatement. The auditor informed management, and the resulting investigation led to identifying cut-off issues as the cause of the misstatement. As a result, the auditor (1) asked management to examine the accounts receivable and rental revenue account balances to identify and correct any other misstatements, and (2) reevaluated her initial risk assessment relating to cut-off and increased the extent of tests of details over rental revenue in order to obtain a higher level of assurance that all material misstatements relating to cut-off errors had been identified.

As indicated in Exhibit 2-1, an auditor cannot assume that an identified error or especially, an instance of fraud is an isolated occurrence. Instead, the auditor needs to consider how the misstatement affects the assessed risks of material misstatement. (Additionally, misstatements may indicate a significant deficiency or material weakness in internal control.) In doing so, the auditor should consider all audit evidence, even if it appears to contradict relevant assertions in the financial statements.

The consideration of risk in a HUD audit also includes an assessment of the risk of material misstatement resulting from noncompliance with laws and regulations that may have a material effect on the determination of financial statement amounts. The consideration also includes an assessment of the risk that the entity has not complied with provisions of laws, regulations, contracts, or grant agreements that may have a direct and material effect on each HUD program.

It is natural to have some deviations in the way controls are applied. Deviations may be caused by such factors as changes in key personnel, seasonal fluctuations in activity, and human error. As a result, controls may not operate as effectively as the auditor had expected. If the auditor detects deviations when performing tests of controls, he makes inquiries to understand such matters and their potential consequences and should determine whether the tests provide an appropriate basis for reliance on the controls, whether additional tests of controls are needed, or whether the potential risks of misstatement need to be addressed by substantive procedures. The auditor should also evaluate whether misstatements identified when performing substantive procedures indicate that the related controls are not operating effectively. However, the absence of identified misstatements when performing substantive procedures does not provide audit evidence that the controls related to the relevant assertion being tested are effective.

At the end of the audit, the auditor should conclude whether sufficient appropriate audit evidence was obtained to reduce to an appropriately low level the risk of material misstatement in the financial statements and to support the opinion on the financial statements. This requires the auditor to evaluate whether the audit was performed at a level that provides the auditor with a high level of assurance that the financial statements, taken as a whole, are free of material misstatement.

AU-C 500 addresses how an auditor evaluates the information to be used as audit evidence, however the auditor's conclusion about the sufficiency and appropriateness of audit evidence, at both the assertion level and the financial statement level, is a matter of the auditor's professional judgment.

The auditor's consideration in the compliance portion of a HUD audit is similar to the consideration in a financial statement audit. In other words, before the conclusion of a compliance audit, the auditor should evaluate whether audit risk of noncompliance has been reduced to an appropriately low level and whether the nature, timing, and extent of the audit procedures need to be reconsidered. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce the risks of material noncompliance with compliance requirements to an appropriately low level. The auditor should consider all relevant audit evidence regardless of whether it appears to corroborate or contradict the relevant assertions.

AU-C 330.29 states that if the auditor has not obtained sufficient appropriate audit evidence with respect to a material financial statement assertion, the auditor should try to obtain additional evidence. If the auditor cannot obtain sufficient appropriate audit evidence, the auditor should either express a qualified opinion or disclaim an opinion.

Evaluating the Existence of Fraud

Fraud Risk Assessment Is an Ongoing Process. Assessing the risks of material misstatement or noncompliance due to fraud is an ongoing process that should occur throughout the audit. Fraud risks may be identified during the engagement acceptance/continuance process, during engagement planning, while obtaining an understanding of internal control, when assessing the risks of material misstatement of the financial statements or noncompliance due to error or fraud, when performing further audit procedures to respond to assessed risks, or when communicating with management or others. Examples of conditions the auditor may note that may change or support the assessment of fraud risks made during planning are included in Exhibit 2-2.

Exhibit 2-2

Conditions That May Change or Support the Auditor's Assessment of Fraud Risks

- Unrecorded transactions or transactions recorded improperly as to account, amount, period, or entity policy.
- Balances or transactions that are unsupported or unauthorized.
- Adjustments made by the entity at the last minute that substantially affect financial results.
- Evidence of employees' unauthorized or unnecessary access to systems or records.
- Missing documents.
- Indications of altered documents.[a]
- Only photocopies or electronic versions of documents being provided to auditors when originals are expected to exist.
- Significant unexplained reconciling items.
- Vague, implausible, or inconsistent responses by the client to the auditor's inquiries.
- Significant amounts of physical assets are missing.
- Denial by client personnel of auditor's access to records, facilities, certain employees, customers, vendors, or others.[b]

- Unusual discrepancies between confirmation rents per leases and the entity's rent roll.
- Failure to retain documents or electronic files consistent with the entity's record retention policies or practices.
- Unusual delays by client personnel in providing requested information.
- Unreasonable time pressures to resolve complex or contentious accounting issues.
- Attempts by management, the project owner, or the management agent to intimidate audit team members or control the conduct of the audit.
- Complaints or tips received by the auditor about fraud or potential fraud.
- Unwillingness to make financial statement disclosures more clear or complete.
- Management's proposal of adjustments, not previously identified or communicated to the auditor, that offset misstatements found by the auditor.
- Evidence of management bias in accounting estimates.

Notes:

a If the auditor suspects that documents have been altered, it may be necessary to engage a document expert to determine their authenticity.

b Denial of access to information may constitute a limitation on the scope of the audit sufficient to preclude unmodified opinions on the financial statements and on compliance.

COVID-19 Fraud Risk Assessment Considerations. Practitioners may wish to review fraud risk factors related to the COVID-19 pandemic along with related considerations such as potential limitations to the scope of the audit. The Auditing Standards Board (ASB) has not released new auditing standards to respond to issues arising from the pandemic, nor has it provided relief from the requirements of currently effective standards. The current auditing standards appear to respond to any COVID-19 related audit issues. The AICPA has, however, provided extensive nonauthoritative COVID-19 resources providing advice on dealing with the accounting and auditing issues created.

Procedures Required by GAAS. AU-C 240.34 requires auditors to evaluate, at or near the completion of fieldwork, whether the accumulated results of auditing procedures (including analytical procedures performed as substantive tests or in the overall review stage of the audit), affect the assessment made earlier in the audit regarding the risks of material misstatement due to fraud or indicate a previously unidentified risk of material misstatement due to fraud. In addition, the auditor is required to perform analytical procedures relating to revenue, through the end of the reporting period. If the full year's revenue information is available during audit planning, the procedures can be performed during preliminary analytical procedures. Otherwise, the procedures performed during planning should be updated during the final analytical review stage of the audit.

Based on the evaluation, the auditor determines whether additional or different audit procedures are necessary. In addition, the auditor should perform a qualitative evaluation of misstatements identified in the financial statements and determine whether the misstatements may indicate possible fraud. Also, communication among the engagement team about information or conditions that indicate potential risks of material misstatement due to fraud should continue throughout the audit.

Additional Requirements Regarding Fraud in an Audit of a HUD Program. In an audit of a HUD program, the auditor should specifically assess the risk that material noncompliance with requirements applicable to the HUD program could occur due to fraud. This assessment relates to fraudulent acts that might result in such noncompliance or in the misappropriation of federal funds.

Paragraph 6.15 of the Yellow Book explains that the AICPA requirements pertaining to the auditor's responsibilities for laws and regulations also apply to consideration of compliance with provisions of contracts or grant agreements. Thus, under both GAAS and the Yellow Book, auditors are required to determine whether those charged with governance are adequately informed about fraud and noncompliance with laws and regulations that could have a material effect on the financial statements. The Yellow Book expands this to include noncompliance with provisions of contracts and grant agreements.

Considerations in Audits of For-profit Entities. According to the HUD audit guide, Paragraph 1-5(A), if the auditor becomes aware of noncompliance with provisions of laws, regulations, contracts, and grant agreements, or fraud that has occurred or is likely to have occurred, the auditor is required to bring such matters to the attention of the appropriate level of management. In addition, the HUD audit guide, Paragraph 2-5, requires the auditor to follow Yellow Book requirements when considering what to report and the extent to which information should be included in publicly available reports. If the circumstances are such that the Yellow Book would require the auditor to report directly to HUD, the auditor should direct such reporting to the HUD OIG single audit coordinator.

If the entity's management fails to meet legal or regulatory requirements to report fraud to external parties specified by a law or regulation, the Yellow Book requires the auditor to first communicate the failure to report the information to those charged with governance. If the information is not reported as soon as practicable after the auditor's communication with those charged with governance, the auditor should report the information directly to the specified external parties. Paragraph 2-5 of the HUD audit guide notes that many HUD-assisted entities do not have an appropriate governance structure and the auditor might be, in effect, reporting management's failure to the same individuals responsible for the fraud. In such cases, the auditor is required to report the matter directly to HUD by contacting the HUD OIG single audit coordinator, preferably before leaving the audit site.

Evaluating Significant Unusual Transactions

Additional substantive procedures that may be needed in particular circumstances depend on the auditor's judgment about the sufficiency and appropriateness of audit evidence in the circumstances. Because of the judgmental nature of the auditor's risk assessments and the inherent limitations of internal control, particularly the risk of management override, some substantive procedures have to be performed in every audit. One of these procedures involved evaluating significant unusual transactions.

AU-C 240.32 requires the auditor to evaluate the business purpose of significant unusual transactions to address the risk of management override of controls by considering whether the business purpose (or lack thereof) suggests that transactions may have been entered into to perpetuate fraudulent financial reporting or conceal misappropriation of assets. In evaluating the business purpose of significant unusual transactions, AU-C 240.32c requires that the auditor's procedures include the following:

- Read underlying documentation and evaluate whether the terms and other information about the transaction are consistent with explanations the auditor has obtained through inquiries or other audit evidence about the business purpose of the transaction.
- Determine whether the transaction has been authorized and approved in accordance with the policies and procedures established by the entity.
- Evaluate whether identified significant unusual transactions have been properly accounted for and disclosed.

AU-C 240.A54 describes the following indicators that may suggest a significant unusual transaction has been entered to engage in fraudulent financial reporting or to conceal misappropriation of assets:

- Transaction form appears overly complex.
- Management failed to discuss the nature of and accounting for the transaction.
- Inadequate transaction documentation.
- Management placed more emphasis on the particular accounting treatment of the transaction than on its economic substance.
- The transaction involved nonconsolidated related parties, including special purpose entities.

- The transaction was not properly reviewed or approved by those charged with governance.
- The transaction involved related parties or relationships or transactions with them that were previously not disclosed to the auditor.
- The transaction involved other parties lacking substance or the financial ability to support the transaction without the entity's, or a related party of the entity's, assistance.
- The transaction lacked commercial or economic substance or was part of a larger series of connected, linked, or otherwise interdependent arrangements lacking commercial substance individually or in the aggregate.
- The transaction falls outside the GAAP definition of a related party, but either party is able to negotiate terms that may not be available to other, more clearly independent parties on an arm's length basis.
- The transaction enables the entity to achieve certain financial targets.

AU-C 240.A55 suggests the following additional procedures for evaluating significant unusual transactions:

- Evaluate the financial capability of the other parties to the transaction in relation to uncollected balances, loan commitments, supply arrangements, guaranties, or other similar arrangements.
- Evaluate the financial capability of a related party by considering information such as the related party's audited financial statements, regulatory agency reports, tax returns, or coverage in financial publications.

Considering the Application of Significant Accounting Principles for Bias

According to AU-C 240.29, the auditor should evaluate whether the application of significant accounting principles indicates a bias on the part of management. In particular, the auditor should consider accounting related to subjective measurements and complex transactions. Intentional misapplication of accounting principles relating to amounts, classification, manner of presentation, or disclosure is one way in which fraudulent financial reporting can be accomplished.

Documentation Requirements

AU-C 230.08 requires auditors to document significant audit findings or issues, the conclusions reached about such findings or issues, and significant professional judgments made in reaching those conclusions. Judging the significance of a finding or issue generally requires an objective analysis of the facts and circumstances.

Evaluation of Presentation and Disclosure

AU-C 330.26 requires the auditor to perform audit procedures to evaluate whether the overall presentation of the financial statements, is in accordance with GAAP, including consideration of whether the financial statements are presented in a manner that reflects the following:

- Appropriate classification and description of financial information and the underlying transactions, events, and conditions.
- Appropriate presentation, structure, and content.

AU-C 330.A73 explains that evaluating appropriate presentation, structure, and content includes consideration of terminology required by GAAP, level of detail provided, aggregation and disaggregation of amounts, and the bases of amounts set forth.

In forming an opinion on financial statements, according to AU-C 700.15, the auditor should evaluate several matters, including the following related to presentation and disclosure, as to whether:

- Significant accounting policies selected and applied are adequately disclosed.
- Information presented is relevant, reliable, comparable, and understandable.

- Disclosures enable intended users to understand the effect of material transactions and events on the information conveyed in the financial statements.
- Terminology used, including the title of each financial statement, is appropriate.

In this evaluation, the auditor considers the presentation, structure, and content of each of the individual financial statements.

Summary of Planning and Performing Audit Procedures for Presentation and Disclosure. An appropriate audit approach to planning and performing audit procedures to evaluate whether the overall presentation of the financial statements, including the related disclosures, is in accordance with GAAP can be summarized as follows:

- Make a preliminary determination of the disclosure information that is material, considering both quantitative and qualitative matters. A review of a disclosure checklist may assist in identifying relevant disclosures.
- As part of performing risk assessment procedures, including during the discussion of the engagement team, identify potential material misstatements in disclosures at the assertion level that could arise due to error or fraud.
- Plan and perform further procedures designed to detect whether material misstatements have occurred at the assertion level in material areas of disclosure that are responsive to the risks of material misstatement.
- Further audit procedures related to disclosures ought to include the following:
  - Procedures for testing the gathering of disclosure information as part of the financial reporting and closing process, including information from outside of the general and subsidiary ledgers.
  - Procedures to agree or reconcile disclosure information with the underlying accounting records and with sources outside of the general and subsidiary ledgers.

THE USE OF ANALYTICAL PROCEDURES

Purposes of Analytical Procedures

AU-C 520.06 requires the use of analytical procedures in the final review stage of the audit. The purpose of analytical procedures at this stage is to identify any unusual or unexpected financial statement relationships not previously identified and to assess whether the information gathered during the audit provides a sufficient understanding of such relationships identified during the planning or final review stages. The auditor assesses whether the financial statements make sense in light of the knowledge and understanding obtained during the audit. When the auditor does not have a sufficient understanding of the cause of an unusual or unexpected relationship, the auditor may need to revise the risk of material misstatement and apply additional audit procedures.

Preliminary analytical procedures are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures are used to consider the adequacy of the procedures performed. Although the objective of applying the procedures may differ, the analytical procedures actually applied may be very similar. At the planning stage, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be applied to amounts after audit adjustment. Thus, in the final review, a comparison to prior period amounts at the financial statement level may be effective.

One common form of documentation is referred to as a *flux analysis*. A flux analysis is a narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period. The authors do not believe a flux analysis is required by AU-C 520, but recommend it as a convenient means of documenting the required thought process. If a flux analysis is performed during preliminary planning and there are few adjustments, the flux analysis can be updated rather than reperformed in the final review.

AU-C 240 requires the auditor to perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Those procedures should be performed through the end of the reporting period. If the full year's revenue information is available during audit planning, the required procedures can be performed during preliminary analytical procedures and updated during the final analytical review stage of the audit.

THE REVIEW OF WORKPAPERS

The review of workpapers near the conclusion of the engagement consists of a detailed review of the audit work of staff assistants and a higher level supervisory review. The supervisory review is often conducted after financial statements and the auditor's report have been drafted and is the final check on whether the audit work supports the overall conclusions on the financial statements.

Authoritative pronouncements establish only broad requirements for supervision and review. AU-C 220A.18–.19 requires the engagement partner to take responsibility for review of the work performed in accordance with the firm's review policies and procedures. Based on the review of audit documentation and discussion with the engagement team, on or before the date of the auditor's report, the engagement partner should be satisfied that sufficient appropriate audit evidence has been gathered to support the conclusions reached and the auditor's reports to be issued.

SQCS No. 8, *A Firm's System of Quality Control*, at QM 10A.35–.36, indicates that a firm should establish policies and procedures that address supervision and review responsibilities. The review responsibility policies and procedures should be determined on the basis that qualified engagement team members review the work performed by other team members on a timely basis. The engagement partner may delegate parts of the review responsibility to other members of the engagement team, in accordance with firm quality control policies. The review may include consideration of factors such as the following (QM 10A.A35 and AU-C 220A.A16):

- The work is performed in accordance with professional standards and regulatory and legal requirements.
- Significant findings and issues are raised for further consideration.
- Appropriate consultations take place and resulting conclusions are documented and implemented.
- The nature, timing, and extent of work performed is appropriate and without need for revision.
- The procedures performed support the conclusions reached and are properly documented.
- Evidence obtained is sufficient and appropriate to support the report.
- The objectives of the procedures performed are achieved.

Auditors are required to document who performed the work and when the work was completed. Likewise, AU-C 230.09 requires that the workpapers indicate who reviewed specific audit documentation and the date and extent of the review. Auditors are not required to indicate their review on each specific workpaper. However, the documentation should clearly indicate who reviewed specified elements of the audit work and when. A practical and efficient way of indicating who reviewed specified elements of the audit work and when is for the detailed reviewer to initial and date the specific workpapers reviewed.

The review of workpapers, particularly the summarization and evaluation of audit differences, may indicate the need to consult with someone not involved in the engagement on complex technical issues. The fact that consultation has taken place (including the nature and scope of the consultation) and the resolution of the issue should be documented in the workpapers as required by AU-C 220A.25d, but *when* consultation is necessary and *with* whom vary considerably. Establishing procedures for consultation and differences of opinion is discussed later in this lesson.

Supervisory Review

Both AU-C 230.09 and *Government Auditing Standards* require the audit documentation (workpapers) to include evidence of supervisory review. Supervisory reviewers should document their review of specific audit documentation and when it occurred. Some reviewers may prefer to document their review in a memo format that indicates the specific workpaper sections reviewed and associated dates.

Government Auditing Standards establishes an additional requirement for supervisory review. Paragraph 6.31 of the Yellow Book indicates that auditors should document evidence of supervisory review of the work performed before the report release date. A GAO official has indicated he would expect to see supervisory initials on "significant" workpapers, such as summary spreadsheets and other "important" workpapers. The supervisory initials may be those of an owner or someone in a supervisory position. (A sole practitioner is not expected to engage another practitioner to review and initial his or her workpapers.)

Generally, the supervisory review focuses more on the summary and evaluation schedules and documentation of significant audit findings or issues, and less time and attention are given to supporting workpaper schedules. It is often conducted after financial statements and auditor's report have been drafted and is the final check on whether the audit work supports the audit reports and the opinions on compliance and on the financial statements. The review of the workpapers should be performed before the date of the auditor's report.

Any review notes or comments from the earlier stages of review need to be satisfactorily resolved by the completion of the supervisory review. The particular practices adopted for documenting and clearing review notes are a matter of individual firm preferences in engagement administration. However, it is important that the resolution be clear and no apparently unanswered or open matters remain in the final workpapers. Once the audit has been completed, all review points and notes need to be removed from the workpapers, as they do not constitute audit evidence.

Review Checklists

Most firms use some form of checklist to serve as a reminder of important engagement completion matters and to document completion of a review of the workpapers. One option is to use pre-made checklists, such as those provided in *PPC's Guide to HUD Audits*. These checklists assist the reviewer in performing and documenting the review.

Sole Practitioners

Obviously, much of this discussion on the various levels of review is not applicable to a sole practitioner who has no assistants. A sole practitioner may have to review his or her own workpapers. Professional standards do not require that audit work necessarily be reviewed by someone other than the person who did the work. QM 10A.A1 notes that the review responsibilities are not relevant when there are no staff. This does not mean, however, that review of completed audit work is unimportant. See the discussion about engagement quality control reviews beginning in the next paragraph. It is still necessary to make a critical review of completed work and evaluate whether the work performed adequately supports the conclusions reached.

Engagement Quality Control Review

Many firms require a review of the audited financial statements, supplementary information, auditor's reports, and other communications and reports by someone who has no other responsibility on the audit. Depending on firm policy, engagement quality control reviews (EQCRs) may also include additional procedures, such as:

a. Looking at the checklists or memoranda that document the review by the audit senior and engagement partner.

b. Reviewing attorneys' letters and the management representation letter.

c. Reading documentation related to the significant judgments made by the engagement team and the conclusions they reached.

d. Discussing significant findings and issues with the engagement partner.

SQCS No. 8 (QM 10A.38) states that a firm should establish criteria against which all audit engagements should be evaluated to determine whether an engagement quality control review should be performed. If performed, SQCS No. 8 (QM 10A.40) states the engagement quality review should be completed before the audit report is released.

The authors recommend that an engagement quality control review be performed on each HUD audit by someone with applicable audit experience and should be documented.

EQCR for Smaller Firms and Sole Practitioners. When sole practitioners or smaller firms identify engagements that require EQCRs, a qualified individual may not be available within the firm to perform the EQCRs. In such cases, qualified external individuals or firms may be contracted to perform the function. When the firm contracts qualified external individuals or other firms, the firm should ensure that they have the appropriate technical qualifications, are objective, and adhere to the requirements of quality control standards regarding engagement quality control review procedures.

When an individual external to the firm is engaged to perform an EQCR, the authors believe the firm needs to devote additional attention to obtaining information about that individual that is relevant to ensuring the individual's independence and compliance with other relevant ethical requirements. A firm is likely to have less information on the individual's financial, family, and other relevant relationships for an audit client than it does for staff members. AU-C 220A.09 indicates that the relevant ethical requirements to which the engagement quality control reviewer is subject include the AICPA *Code of Professional Conduct*, rules of applicable state boards of accountancy, and applicable regulatory agencies. This means that the external individual performing an EQCR is subject to the same independence and other ethical requirements as the engagement team. The EQCR should affirm that he or she is familiar with the applicable independence requirements and the firm needs to request any information that might be considered to have a bearing on independence of the reviewer. There also needs to be some investigation into and documentation of the EQCR's applicable qualifications, such as experience, education, and licensure.

Timing of Review of Workpapers

AU-C 700.42 requires that the date of the auditor's report should be no earlier than the date that sufficient appropriate audit evidence has been obtained to support the opinion on the financial statements. AU-C 220A.19 requires that by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. The authors believe that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220A.A17 observes that the engagement partner may review all audit documentation, but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent. AU-C 220A.21 notes specifically that for those engagements for which the firm determines an engagement quality control review is required, the review should be completed prior to the release of the audit report.

PROCEDURES FOR SUMMARIZATION AND EVALUATION

Introduction

One of the final steps near completion of the engagement is evaluation of (a) the misstatements of the financial statements and (b) the findings of noncompliance found during fieldwork. In a HUD audit, the summarization and evaluation procedures related to the financial statement audit and the compliance audit are usually performed concurrently. This section begins by focusing on evaluating and summarizing the results of the financial statement audit. Many of the requirements and concepts in GAAS used in that discussion also apply in the discussion about evaluating the effects of noncompliance on the financial statements that follow.

As previously discussed, near the end of the audit, auditors are required to evaluate whether the accumulated results of the auditing procedures performed provide a high level of assurance that the financial statements, as a whole, are free of material misstatement. That evaluation includes consideration of misstatements discovered during fieldwork, including whether identified misstatements are indicative of possible fraud. This section on summarization and evaluation concludes with a discussion about evaluating the existence of fraud.

Evaluating Financial Statement Misstatements

AU-C 450, *Evaluation of Misstatements Identified During the Audit*, provides guidance for evaluating misstatements. AU-C 450.11 requires that the individual and combined effects of all uncorrected misstatements be considered to determine whether they are material to the financial statements taken as a whole. To evaluate the combined effect of various uncorrected misstatements, it is necessary to summarize them in one place in the workpapers.

Categories for Evaluation. The categories of misstatements and the format used to summarize them are matters of individual firm preference. The authors use the following classifications in this course:

a. *Normal Closing Entries.* These are routine entries, such as adjustments of accruals, that are made to help the client close out the books for the year. If normal closing entries are booked, they *are not misstatements* and should not be included in the summary of audit differences. The authors also believe that normal closing entries ordinarily are not significant findings or issues that would be subject to the documentation requirements of AU-C 230, *Audit Documentation*. If the auditor chooses to use a practice aid form to accumulate normal closing entries during the audit, it is often useful to group all those entries in one place. Grouping closing entries in one place is more convenient for supervisory review and discussion with the client. It is necessary for the client to agree with booking these entries and accept responsibility for them because the financial statements are the client's responsibility.

b. *Audit Differences.* These are any differences noted between the accounting records and the evidence obtained during the audit. An audit difference could be any of the following:

   (1) Passed adjustment for a specifically identified misstatement.

   (2) Projected misstatement from a substantive audit sampling application.

   (3) Significant unexplained difference from an analytical procedure that is treated like a misstatement.

   (4) Difference between the client's accounting estimate and the relevant end of the auditor's acceptable range for that estimate.

   (5) Differences noted between the accounting records and the evidence obtained during the audit that should result in the project owner having to refund monies or make other restitution to HUD.

Definition of a Misstatement. AU-C 450.04 describes the following characteristics that together comprise the definition of a misstatement:

- A difference between the reported amount, classification, presentation, or disclosure and the amount, classification, presentation, or disclosure required for a financial statement item to be presented fairly in accordance with GAAP.
- Can arise from either error or fraud.
- Includes adjustments of amounts, classifications, presentations or disclosures necessary to achieve fair presentation of financial statements.

Misstatements are also often referred to as audit differences, which include both differences in reported amounts and differences related to disclosures or presentation.

Examples of Misstatements. AU-C 450.A1 provides the following examples of misstatements that may result from error or fraud:

- An inaccuracy occurs in gathering or processing data for inclusion in the financial statements.
- A financial statement amount is omitted.
- A financial statement disclosure is omitted (including inadequate, incomplete, or other disclosures failing to meet disclosure objectives of GAAP).
- A financial statement disclosure is not presented in accordance with GAAP.
- An incorrect accounting estimate results from an oversight or misinterpretation of facts.
- Unreasonable or inappropriate judgments by management occur concerning application of accounting policies or accounting estimates.
- Information is inappropriately classified, aggregated or disaggregated.
- A disclosure is omitted that is necessary for the financial statements to achieve fair presentation beyond disclosures specifically required by GAAP.

The last example includes situations in which information may have to be disclosed to make the information disclosed not be misleading. In some circumstances, literal compliance with the specifically enumerated disclosure requirements of FASB ASC topics may not be sufficient for the financial statements to be fairly presented. For example, disclosure of the amount of borrowing and lending among related parties during the period may not be sufficient to alert users of the financial statements that a dominant related party is defrauding the other parties to the transactions.

Misstatements versus Normal Closing Entries. The authors believe a distinction is necessary between misstatements and normal closing entries. There are routine entries typically necessary to assist smaller entities in the closing process, such as accruals, depreciation, and income tax accounting adjustments. A smaller entity's need for this type of assistance may represent a significant deficiency or material weakness in controls, but the authors believe an auditor may appropriately regard these typical adjustments as not being misstatements as that term is used in AU-C 450 and not significant findings or issues subject to the documentation requirements of AU-C 230.

Grouping the normal closing entries is more convenient for supervisory review purposes and discussion with management. The normal closing entries have to be agreed to by management and management has to accept responsibility for them. An auditor may prepare a separate memorandum on normal closing entries, or include them with audit adjustments.

Categories of Misstatements. AU-C 450.A6, as amended, describes the following terms that distinguish among three categories of misstatements, that auditors may find beneficial in evaluating the effect of misstatements accumulated during the audit and communicating misstatements to management and those charged with governance:

a. *Factual misstatement.* This is a misstatement about which there is no doubt.

b. *Judgmental misstatement.* A *judgmental misstatement* is one that arises from judgments made by management including differences related to recognition, measurement, presentation, and disclosure (including selection or application of accounting policies) that are considered unreasonable or inappropriate by the auditor.

c. *Projected misstatement.* This type of misstatement is the result of the auditor's best estimate of misstatement extrapolated to entire populations arising from the use of sampling procedures.

Factual misstatements are observed directly by the auditor when performing audit procedures. For example, rental income recorded using the wrong rate is a factual misstatement. Judgmental and projected misstatements, while not actually observed by the auditor, arise from procedures performed during the audit. For example, the auditor may determine through performance of procedures to evaluate the adequacy of the allowance for bad debts that the entity's bad debt expense is unreasonable given historical trends, resulting in the identification of a judgmental misstatement. Additionally, the auditor may determine the amount of a projected misstatement based upon the results of a sampling application indicates there is an unacceptable risk the recorded amount is materially misstated.

AU-C 450 establishes requirements and provides guidance on consideration of identified misstatements as the audit progresses, and on evaluating the effect of any uncorrected misstatements on the auditor's conclusion about the appropriate opinion on the financial statements. The required steps for the evaluation of misstatements identified during the audit are as follows:

a. Accumulate identified misstatements (AU-C 450.05).

b. Communicate accumulated misstatements to management for correction (AU-C 450.07–450.09).

c. Evaluate effect of uncorrected misstatements that remain (AU-C 450.10–450.11).

Also, as the audit progresses, the auditor will have determined whether the identified misstatements indicate a need to revise the initial overall audit strategy and plan (AU-C 450.06).

Accumulation of Identified Misstatements. AU-C 450.05 requires the auditor to accumulate misstatements identified during the audit except for those that are clearly trivial. Long before this accumulation requirement was incorporated in auditing standards, auditors had followed the practice of setting an amount below that detected misstatements were not posted to a summary of misstatements. This practice was sometimes called *adjustments passed at the workpaper level* or *passed adjusting entries* (PAJEs). The auditing standards label these adjustments as clearly trivial misstatements and provide an explanation and guidance for considering them.

Clearly Trivial Misstatements. AU-C 450.A2 indicates that *clearly trivial* is not synonymous with *not material*. Clearly, trivial misstatements of reported amounts are of a wholly smaller order of magnitude than those determined to be immaterial and are clearly inconsequential, individually or in the aggregate, measured against any criteria of size, nature, or circumstance. In other words, they are inarguably unimportant in either a quantitative or qualitative sense. Similarly, qualitative disclosure or presentation misstatements are of a wholly different nature than those determined to be material judged by any criteria of nature or circumstance.

Accumulation of Misstatements of Reported Amounts. Misstatements include both differences in reported amounts of financial statement items and also differences in financial-statement classifications, presentation or disclosures. The accumulation of audit differences in reported amounts that are not clearly trivial can be accomplished by posting to a workpaper summarizing the differences, such as the form provided in *PPC's Guide to HUD Audits*. This form facilitates the accumulation of individual audit differences in reported amounts by important totals and subtotals for individual financial statements: total assets, total liabilities, working capital, and equity for the balance sheet; and income before taxes, income taxes, and net income for the income statement.

Accumulation of Misstatements in Disclosures. AU-C 450.A4 points out that misstatements in disclosures that are not clearly trivial also have to be accumulated in order to evaluate the effect of the misstatements on the relevant disclosures and the financial statements as a whole. An auditor decides what misstatements in disclosures are to be evaluated by considering their size, nature, and circumstances. Misstatements in disclosures are evaluated primarily by considering their nature or circumstances (that is, their qualitative aspects). AU-C 450.A5 observes that misstatements in the nature or circumstance of disclosures cannot be added together in the way misstatements of reported amounts are summarized, but that the auditor is still required by AU-C 450.11 to evaluate those misstatements both individually and in the aggregate to evaluate their materiality. An auditor may prepare a workpaper memorandum that identifies all the misstatements in disclosures and the qualitative considerations to evaluate them individually and collectively with other misstatements.

Communication and Correction of Misstatements. AU-C 450.07 requires the auditor to communicate to management on a timely basis all misstatements accumulated during the audit, other than clearly trivial ones. AU-C 450.A6 suggests that distinguishing the categories of misstatements identified is beneficial to the communication with management and those charged with governance. AU-C 450.07–.09 also requires the following related to the communication and correction of misstatements:

- Ask the appropriate level of management to correct accumulated misstatements. (Accumulated misstatements do not include those that are clearly trivial.)

- After the detection of a misstatement, the auditor may request management to examine account balances, transaction classes, or disclosures and make appropriate corrections. Additionally, when the auditor detects a judgmental misstatement involving an estimate, the auditor may request management to review the assumptions and methods it used in developing the estimate. Following the correction of detected misstatements, the auditor should perform additional procedures to determine whether misstatements still remain.
- If management decides not to correct some or all of the misstatements, the auditor should obtain an understanding of management's reasons for not correcting the misstatements and take that into account when making the qualitative considerations discussed later in this section. The auditor should also consider the implications for the audit reports. Uncorrected misstatements are significant audit findings under AU-C 260.13 and should be communicated to those charged with governance. The auditor's communication and reporting responsibilities for significant audit findings are discussed later in this lesson.

When communicating accumulated misstatements, AU-C 450.A9 indicates that the appropriate level of management is the one that has responsibility and authority to evaluate misstatements and take the necessary corrective action. The authors recommend that management be strongly encouraged to correct all identified misstatements, including those communicated by the auditor. AU-C 450.A11 observes that correcting all misstatements enables management to maintain accurate books and records and diminishes the risks of future financial statements becoming materially misstated because of the cumulative effect of immaterial uncorrected misstatements in prior years. The auditor should be aware that laws or regulations might restrict communication of certain misstatements to management or others within the entity. As explained in AU-C 450.A10, laws or regulations might specifically prohibit a communication or other action that might prejudice an ongoing investigation by an appropriate authority.

For many smaller nonpublic companies and nonprofit organizations, management will have corrected all nontrivial misstatements and remaining uncorrected misstatements will be limited. Generally, management will record factual misstatements. For judgmental misstatements, management may challenge the auditor's assumptions about the misstatement and resolve any differences in those assumptions to determine if an adjustment should be made. For projected misstatements, management may examine the population to determine the actual misstatements in the population.

Evaluation of Uncorrected Misstatements

AU-C 450.10 requires that before evaluating the effect of uncorrected misstatements, the auditor reassesses whether the materiality judgments made in planning, and possibly revised as the audit progressed, remain appropriate. For example, the entity's financial results after misstatements have been communicated to management and corrected may be significantly different than the amount considered in establishing planning materiality.

After reassessing materiality and communicating accumulated misstatements to management for consideration and correction, some uncorrected misstatements may remain. AU-C 450.11 requires the auditor to determine whether uncorrected misstatements are material individually or in the aggregate by considering the size, nature, and circumstances of the misstatements and the effect of prior-period uncorrected misstatements in relation to classes of transactions, account balances, or disclosures and the financial statements as a whole.

Evaluating Uncorrected Misstatements of Reported Amounts. AU-C 450.A22 indicates that each individual misstatement of an amount is considered to evaluate the effect on relevant classes of transactions, account balances, or disclosures, including whether for that particular item the materiality level has been exceeded. Both the quantitative and qualitative aspects of materiality are considered for each individual misstatement.

In evaluating the materiality of uncorrected reported amounts, an auditor considers their size, nature, and circumstances of occurrence. The size of the misstatement, as a starting point, may be compared to the materiality level established in planning for the financial statements taken as a whole, and the levels for particular classes of transactions, account balances, or disclosures. If planning levels have been revised because the auditor concluded lower levels were appropriate before completing the audit, then those lower levels would be used. An auditor may also decide to use a different benchmark or percentage than that used in planning based on information obtained during the audit. An auditor then considers whether qualitative considerations would cause amounts below this size to be material. The authors stress that the evaluation of materiality of uncorrected reported amounts has to consider the combined effect of qualitative and quantitative factors. Making separate judgments about the quantitative effect of the size of a misstatement and then considering individual qualitative factors from a published list one at a time is not consistent with accounting or auditing standards on materiality.

To meet requirements of AU-C 450.11 to determine whether uncorrected misstatements are material in the aggregate, an auditor typically prepares a summary of misstatements of reported amounts.

Evaluating Uncorrected Misstatements of Qualitative Disclosures. Misstatements in qualitative disclosures may be considered material either individually or in combination with other misstatements.

AU-C 450.A23 indicates that each individual misstatement of a qualitative disclosure has to be considered both in relation to the effect on the relevant individual disclosure and the overall effect on the financial statements as a whole and provides the following examples of such misstatements that may be material:

- Information about the objectives, policies, and processes for managing capital that is incomplete or inaccurate.
- Information about events or circumstances leading to an impairment loss that is omitted.
- Incorrect description of a significant accounting policy.
- Inadequate information on the sensitivity of an exchange rate.

When considering the combined effect of misstatements of qualitative disclosure, AU-C 450.A24 indicates the auditor may consider whether:

- Several identified misstatements are relevant to the same matter and collectively affect users' understanding of that matter.
- Identified misstatements are pervasive or recurring.

Additional Examples of Qualitative Considerations. An auditor's overall judgment about whether a misstatement is material is influenced by qualitative considerations as well as quantitative considerations. The consideration of qualitative factors may cause the auditor to conclude that a quantitatively small misstatement is material to the financial statements. AU-C 450.A28 indicates that some misstatements surrounding circumstances (qualitative considerations) may cause the auditor to conclude they are material, individually or when aggregated with other misstatements, even if they are lower than the amount previously designated as material to the financial statements as a whole. The nature of misstatements in qualitative disclosures dictates that the evaluation of materiality is based on qualitative factors such as those described above. Following are several examples of qualitative factors that may be considered in evaluating the materiality of the effect of misstatements on transaction classes, account balances, and disclosures.

a. *Effect on Other Financial Statement Components.* Some misstatements may not be significant by themselves but could result in events or conditions that materially affect the financial statements. Other misstatements may be pervasive to the financial statements (that is, affecting numerous financial statement amounts, subtotals, or totals).

b. *Effect on Trends, Especially Trends in Profitability.* A misstatement might be immaterial to net income for the current period but material to the overall trend of earnings, such as a misstatement that reverses a downward trend of earnings or changes a loss into income. Also, a misstatement might mask a change or other trend, especially in the context of general economic and industry conditions. For example, a misstatement may mask a decline in loss reserves when economic or industry conditions would result in expectations of reserve increases.

c. *Significance of the Financial Statement Element or Portion of the Entity's Business Affected by the Misstatement.* For example, a misstatement affecting recurring earnings might be considered material whereas a misstatement of the same amount involving a nonrecurring charge or credit might not be considered material. Similarly, a misstatement affecting a portion of the client's business that has been represented as significant to the entity's future operations or profitability might be more material than a misstatement of the same amount affecting another portion of the business.

d. *Effect on Compliance.* A misstatement might affect the entity's compliance with loan covenants, other contractual agreements, or regulatory provisions. For example, a small misstatement affecting working capital might be material if correcting it would reveal a default under a debt covenant.

e. *The Existence of Statutory or Regulatory Requirements Affecting Materiality Thresholds.* Deficiencies in disclosures of related-party transactions or those required by statute or regulatory authority might be considered material even though similar amounts for more routine items might be considered immaterial.

f. *Effect on Management's Compensation.* A misstatement might affect management's compensation (for example, meeting an earnings target might trigger a bonus).

g. *Incorrect Selection or Application of Accounting Policy.* A misstatement related to the incorrect selection or application of an accounting policy may have a material effect on future periods' financial statements even though the effect on the current period is immaterial.

h. *Effect on Ratios.* A misstatement may alter ratios used to evaluate the entity's financial position, results of operations, or cash flows.

i. *Effect on Segment Information.* A misstatement may affect a segment presented in the financial statements that plays an important role in the business.

j. *Known Previous Communications to Users.* A misstatement may significantly alter information previously communicated to users. For example, the misstatement may impact a forecasted earnings amount that was previously communicated.

k. *Involvement of Particular Parties.* The misstatement is related to transactions involving particular parties. For example, the external parties to the transaction are related to members of management or the board of directors.

l. *Significance of Omitted Information That Is Not Required.* The omission of information not specifically required by the applicable financial reporting framework may, in the auditor's professional judgment, be important to the users' understanding of the financial position, financial performance, or cash flows of the entity.

m. *Effect on Other Information in Documents Containing Audited Financial Statements.* The misstatement may impact other information that is communicated in documents containing the audited financial statements that may be utilized by users of the financial statements. For example, the misstatement might impact information presented in a "Management's Discussion and Analysis" that might reasonably be expected to influence the economic decisions of users.

n. *Sensitivity of the Circumstances.* For example, implications of misstatements involving fraud, possible instances of noncompliance with laws or regulations, violations of contractual provisions, or conflicts of interest could be significant.

o. *The Effects of Misclassifications.* The effects of misclassifications could be significant to the financial statement users, for example, a misclassification between operating or recurring income and nonoperating or nonrecurring income.

p. *Significance of the Misstatement or Disclosures in Relation to Reasonable User Needs.* For example, a misstatement that affects equity amounts could be material to creditors of a private company, or a misstatement could have a significant effect on the calculation of purchase price if the entity is being acquired.

q. *Character of the Misstatement.* Some misstatements, such as factual (known) misstatements, can be precisely quantified. Others involve a degree of subjectivity through estimation, allocation, or uncertainty. The auditor needs to be cautious about offsetting precise adjustments (sometimes referred to as "hard") with much less precise adjustments (sometimes referred to as "soft"). For example, a large revenue cutoff error might be individually material even if it could be offset by an estimated overage in the allowance for inventory obsolescence. In that situation, the auditor may recommend that the client book an adjustment for the cutoff error and not book an adjustment for the other audit difference.

r. *Motivation of Management.* Misstatements may indicate a possible pattern of bias by management in the development of accounting estimates. Misstatements may also be caused by management's continued unwillingness to correct weaknesses in the entity's internal control or intentional decision not to follow GAAP.

s. *Offsetting Misstatements.* An individually significant misstatement may be offset by a different misstatement that is also individually significant. Auditors need to use caution when aggregating individually significant misstatements with misstatements in other financial statement components.

t. *Potential Effect on Future Periods.* A misstatement that is currently immaterial may have a material effect in future periods because, for example, of a cumulative effect or a favorable (or unfavorable) turnaround effect.

u. *Cost of Making the Correction.* On one hand, it may not be cost-beneficial for management to develop a system to calculate and correct small misstatements. On the other hand, if there is little cost to calculate and record immaterial corrections, failure to do so may be an indication of management motivation to manage earnings.

v. *Risk That Possible Additional Undetected Misstatement Would Affect the Evaluation.* See the discussion of further misstatement.

The items in the above list are only examples of qualitative factors that may be pertinent to the auditor's evaluation of materiality. The auditor should consider additional qualitative factors that may exist. If the auditor believes a misstatement is, or may be, the result of fraud, the auditor should consider the implications of the misstatement in relation to other aspects of the audit, even if the effect of the misstatement is not material to the financial statements.

Risk of Possible Undetected Misstatements and Overall Evaluation. AU-C 450.A8 indicates that even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor recognizes that there is a risk that the financial statements may be materially misstated due to further undetected misstatements. If combined uncorrected misstatement is very close to the amount an auditor considers material to the financial statements taken as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers $20,000 material and uncorrected misstatement is $5,000, the risk of further misstatement of $15,000 may be considered acceptably low. If combined uncorrected misstatement is closer to $20,000, the risk may be considered unacceptable. In that case, the auditor needs to perform additional procedures or determine that the entity appropriately adjusts the financial statements.

Evaluating the Existence of Fraud

According to AU-C 240.35, if the auditor identifies a misstatement, the auditor should evaluate whether it is indicative of fraud and the implications for the audit, including evaluation of materiality, management and employee integrity, and the reliability of management representations. An identified instance of fraud is unlikely to be an isolated occurrence. If the auditor believes or suspects that a misstatement, whether material or not, is a result of fraud and management (in particular, senior management) is involved, AU-C 240.36 indicates that the auditor should reevaluate the assessment of the risks of material misstatement due to fraud and the effect on the nature, timing, and extent of audit procedures. Additionally, the auditor should consider whether it indicates collusion involving employees, management, or third parties when reconsidering the evidence previously obtained. Questions about management's integrity may raise doubts about the auditor's ability to rely on representations made during the audit, as well as accounting records and documentation. If the auditor concludes that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should evaluate the implications for the audit.

AU-C 450.A29 notes that misstatements in disclosures may also be indicative of fraud and offers the following examples:

- Management's biased judgments result in misleading disclosures.
- To obscure proper understanding, extensive duplicative or uninformative disclosures are included in the financial statements.

Considerations if the Auditor Withdraws or the Engagement Is Terminated. In some cases, the risk of material misstatement of the financial statements due to fraud is so significant that auditors question their ability to continue performing the audit. In that case, AU-C 240.38 states the auditor should determine his or her professional and legal responsibilities, such as whether a requirement exists to report the circumstances to those who engaged the auditor or, if applicable, to regulatory authorities. Additionally, the auditor should consider whether it is appropriate to withdraw from the engagement (when withdrawal is possible under applicable law or regulation). Withdrawal requires the auditor to (a) discuss the withdrawal and the reasons for it with the appropriate level of management and those charged with governance and (b) determine whether there is a professional or legal requirement to report the withdrawal and the reasons for it to the party who engaged the auditor, or to regulatory authorities. The decision to withdraw may depend on whether the identified risks call into question the integrity of management and whether management or others with oversight are diligent and cooperative in investigating the situation and taking appropriate action. The authors believe that auditors considering withdrawal should consult with legal counsel.

<u>Considerations in Audits of For-profit Entities.</u> In accordance with the HUD audit guide, the auditor has additional communication responsibilities if the client terminates the audit or the auditor withdraws from the engagement. Paragraph 1-6 of the HUD audit guide requires the auditor of a for-profit HUD entity to notify the HUD OIG single audit coordinator and the HUD servicing program office in writing if either situation occurs. The letter or report should include a detailed explanation for the withdrawal or termination.

If the reason for the withdrawal or termination is possible fraud or equity skimming, the HUD audit guide, Paragraph 2-5, requires the auditor to follow Yellow Book requirements when considering what to report and the extent to which information should be included in publicly available reports. If the circumstances are such that the Yellow Book would require the auditor to report directly to HUD, the auditor should direct such reporting to the HUD OIG single audit coordinator.

Evaluating Overall Materiality for the Financial Statements

The combined effect of uncorrected misstatements on various financial statement components (amounts, subtotals, or totals) should be compared to the amount that the auditor considers material to the financial statements taken as a whole. The auditor's judgments about materiality in audit planning may be different than materiality used in evaluating audit findings because it is not possible to anticipate everything that could ultimately influence judgments about materiality when evaluating audit findings at completion of the audit. For example, while performing the audit, the auditor may become aware of quantitative or qualitative factors that were not initially considered but could be important to users of the financial statements. Those factors should be considered in making materiality judgments about audit findings. If the auditor concludes that a lower materiality level than initially determined is appropriate, the auditor should reconsider performance materialities and appropriateness of the nature, timing, and extent of further audit procedures. If the nature of identified misstatements and the circumstances of their occurrence indicate that other misstatements may exist that could be material when aggregated with identified misstatements, the auditor should also consider whether the overall audit strategy and audit plan need to be revised.

AU-C 450.A8 indicates that even if the auditor concludes that the effects of uncorrected misstatements, individually or in the aggregate, do not cause the financial statements to be materially misstated, the auditor recognizes that there is a risk that the financial statements may be materially misstated due to further undetected misstatements. If combined uncorrected misstatement is very close to the amount an auditor considers material to the financial statements taken as a whole, the risk of further misstatement may be considered unacceptable. For example, if an auditor considers $20,000 material and uncorrected misstatement is $5,000, the risk of further misstatement of $15,000 may be considered acceptably low. If combined uncorrected misstatement is very close to $20,000, the risk may be considered unacceptably high. In that case, the auditor needs to perform additional procedures or determine that the financial statements are adjusted appropriately.

Evaluating Noncompliance

In the compliance audit portion of a HUD audit, the objective of testing compliance is to enable the auditor to express an opinion on whether the entity complied, in all material respects, with applicable compliance requirements, noncompliance with which *could* have a material effect on each major HUD program.

When assessing the effect of instances of noncompliance, individually or in the aggregate, the auditor first considers the type and nature of the noncompliance finding as well as the actual and projected effect on each program in which the noncompliance is noted. When applicable, the dollar value or questioned cost related to the finding is quantified. A questioned cost is an amount spent by a recipient of HUD funds that may not be in compliance with applicable laws or regulations. [AU-C 935.11 defines *questioned costs* as those that are questioned by the auditor because (a) they violate (or may violate) applicable compliance requirements, (b) they are not supported by adequate documentation, or (c) they appear unreasonable and do not reflect what a prudent person would do in the circumstances.] When sampling is used in the compliance audit and questioned costs are found in the sample, the auditor projects the amount of questioned costs found in the sample to estimate likely questioned costs.

Evaluating the Financial Statement Effect of Noncompliance Findings. In summarizing the results of the compliance audit, the auditor has to combine, or aggregate, all likely questioned costs to evaluate the effect on the entity's HUD programs and on the entity's financial statements. Likely questioned costs, of course, include known questioned costs. It is necessary to combine individually immaterial noncompliance findings to evaluate the materiality of the effect on the individual HUD programs and on the financial statements taken as a whole. To evaluate the combined effect of noncompliance findings, it is necessary to summarize them in one place in the workpapers. A variety of formats could be used to summarize noncompliance findings.

After summarizing noncompliance findings, the combined monetary effect needs to be compared to the amount that the auditor considers material to the financial statements taken as a whole. There are several factors that the auditor considers when evaluating materiality. Those factors include both qualitative considerations and the risk of further undetected noncompliance. An auditor is not "locked-in" to the preliminary judgment about materiality made at the start of the audit. At that point, materiality is established as a practical necessity in planning. After the audit is nearly completed, an auditor will have additional knowledge and may have a different perspective, and that may change the auditor's judgment on materiality.

Other Considerations of the Effect of Noncompliance on the Financial Statements. The auditor should also consider the broader implications of questioned costs for the audit of the financial statements. AU-C 240.35 explains the auditor should evaluate whether financial statement misstatements may be due to fraud. If fraud is indicated, the auditor should also consider whether the risk assessment made during planning is still appropriate and whether the conditions or circumstances indicate the likelihood of material misstatement of the financial statements.

Consultation on Technical Issues and Differences of Opinion

Some firms designate specialists in particular industries or in certain topics, such as income taxes. The extent of specialization varies with firm size and individual firm preference. On particularly complex matters, outside consultation may be advisable. The firm's consultation procedures should provide for consultation with those having appropriate knowledge, seniority, and experience within the firm, on significant technical, ethical, and other matters. Such procedures should also provide for appropriate documentation and implementation of conclusions resulting from consultations. SQCS No. 8 (QM 10A) states that the appropriate documentation of consultations that is sufficiently complete and detailed contributes to an understanding of the issue on which consultation was sought. Such complete and detailed documentation helps provide understanding of the results of the consultation, including decisions made, the basis for those decisions, and how the decisions were implemented.

Audit firms need to have some mechanism for addressing and resolving differences of opinion between engagement team members or between the engagement partner and the engagement quality control reviewer. SQCS No. 8 (QM 10A.46–.48) indicates that an audit firm's policies and procedures for addressing and resolving differences of opinion should require that (a) conclusions reached be documented and implemented and (b) the audit report not be released until the matter is resolved.

PPC's Guide to Quality Control discusses consultation and differences of opinion in more detail. Differences of opinion among engagement team members, with those consulted, or between the engagement partner and engagement quality control reviewer concerning engagement issues, should be documented. In addition, significant issues, consultations, conclusions, and the basis for conclusions relating to decisions to withdraw from an engagement or from both the engagement and the client relationship should also be documented. Documentation should include the conclusions reached regarding the differences and how those conclusions were implemented. The report should not be released any and all such matters are resolved.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

16. Which of the following statements is correct regarding an auditor's specific additional requirements and responsibilities related to fraud in an audit of a HUD program?

    a. The auditor should assess the risk that material noncompliance with HUD program requirements could occur due to fraud.

    b. Auditor responsibilities for laws and regulations do not apply to considering compliance with contracts or grant agreements.

    c. The auditor should determine if the entity's shareholders have been properly informed of fraud and noncompliance.

    d. There are no additional assessments the auditor should make regarding fraud in an audit of a HUD program.

17. Which of the following statements most accurately describes an issue related to analytical procedures?

    a. An auditor can choose whether to use analytical procedures in final review based on the facts and circumstances.

    b. Final review analytical procedures are performed to amounts after audit adjustments.

    c. Final review analytical procedures help the auditor obtain an understanding of the entity and its environment.

    d. Analytical procedures performed during final review are different from preliminary analytical procedures.

18. Which of the following is correct regarding the supervisory review of audit workpapers?

    a. It must be performed prior to drafting the audit report.

    b. It typically focuses more on the summary and evaluation schedules.

    c. Review notes should be saved and resolved in the next year's audit.

    d. The Yellow Book establishes a precise method for recording and clearing review notes.

19. Which auditor has correctly handled an issue related to the communication and correction of misstatements?

    a. Camina detects a judgmental misstatement in an estimate, so she researches the assumptions used in its development.

    b. Klaus advises management that he will be correcting the accumulated misstatements discovered during the audit.

    c. Naomi timely communicates all misstatements discovered during the audit, omitting the clearly trivial ones.

    d. After James confirms detected misstatements were corrected, he performs no other procedures checking for remaining misstatements.

SELF STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

16. Which of the following statements is correct regarding an auditor's specific additional requirements and responsibilities related to fraud in an audit of a HUD program? **(Page 72)**

    a. **The auditor should assess the risk that material noncompliance with HUD program requirements could occur due to fraud. [This answer is correct. In an audit of a HUD program, the auditor should specifically assess the risk that material noncompliance with requirements applicable to the HUD program could occur due to fraud. This assessment relates to fraudulent acts that might result in such noncompliance or in the misappropriation of federal funds.]**

    b. Auditor responsibilities for laws and regulations do not apply to considering compliance with contracts or grant agreements. [This answer is incorrect. The Yellow Book explains that the AICPA requirements pertaining to the auditor's responsibilities for laws and regulations *also apply* to consideration of compliance with provisions of contracts or grant agreements. Thus, an auditor should recognize his or her responsibilities for both.]

    c. The auditor should determine if the entity's shareholders have been properly informed of fraud and noncompliance. [This answer is incorrect. Under both GAAS and the Yellow Book, auditors are required to determine whether those charged with governance (not the shareholders) are adequately informed about fraud and noncompliance with laws and regulations that could have a material effect on the financial statements.]

    d. There are no additional assessments the auditor should make regarding fraud in an audit of a HUD program. [This answer is incorrect. Additional requirements do exist when performing a HUD audit to assess for a particular issue that could result due to fraud. Thus, a different answer is required.]

17. Which of the following statements most accurately describes an issue related to analytical procedures? **(Page 75)**

    a. An auditor can choose whether to use analytical procedures in final review based on the facts and circumstances. [This answer is incorrect. AU-C 520.06 *requires* the use of analytical procedures in the final review stage of the audit. The purpose of analytical procedures at this stage is to identify any unusual or unexpected financial statement relationships not previously identified and to assess whether the information gathered during the audit provides a sufficient understanding of such relationships identified during the planning or final review stages.]

    b. **Final review analytical procedures are performed to amounts after audit adjustments. [This answer is correct. At the planning stage, analytical procedures will be applied to unaudited amounts. In the final review stage, the procedures will be applied to amounts after audit adjustment. Thus, in the final review, a comparison to prior period amounts at the financial statement level may be effective.]**

    c. Final review analytical procedures help the auditor obtain an understanding of the entity and its environment. [This answer is incorrect. Preliminary (not final) analytical procedures are risk assessment procedures performed to obtain an understanding of the entity and its environment for the purpose of assessing the risks of material misstatement and determining what further audit procedures should be performed in response to the risk assessment. Final review analytical procedures are used to consider the adequacy of the procedures performed.]

    d. Analytical procedures performed during final review are different from preliminary analytical procedures. [This answer is incorrect. Although the objectives of applying final review and preliminary analytical procedures may differ, the analytical procedures actually applied may be very similar.]

18. Which of the following is correct regarding the supervisory review of audit workpapers? **(Page 77)**

    a. It must be performed prior to drafting the audit report. [This answer is incorrect. The supervisory review is often conducted after the financial statements and auditor's report have been drafted (it is not required to be performed before that) and is the final check on whether the audit work supports the audit reports and the opinions on compliance and on the financial statements.]

    b. **It typically focuses more on the summary and evaluation schedules. [This answer is correct. Generally, the supervisory review focuses more on summary and evaluation schedules and documentation of significant audit findings or issues, and less time and attention are given to supporting workpaper schedules.]**

    c. Review notes should be saved and resolved in the next year's audit. [This answer is incorrect. Any review notes or comments from the earlier stages of review need to be satisfactorily resolved by the completion of the supervisory review, not held until next year.]

    d. The Yellow Book establishes a precise method for recording and clearing review notes. [This answer is incorrect. The particular practices adopted for documenting and clearing review notes are a matter of individual firm preferences in engagement administration, not precisely detailed in the Yellow Book. However, it is important that the resolution be clear and that no apparently unanswered or open matters remain in the final workpapers.]

19. Which auditor has correctly handled an issue related to the communication and correction of misstatements? **(Page 81)**

    a. Camina detects a judgmental misstatement in an estimate, so she researches the assumptions used in its development. [This answer is incorrect. When the auditor detects a judgmental misstatement involving an estimate, the auditor may request management to review the assumptions and methods it used in developing the estimate. Camina would not review the information herself.]

    b. Klaus advises management that he will be correcting the accumulated misstatements discovered during the audit. [This answer is incorrect. Per the guidance in AU-C 450.07–.09, Klaus should ask the appropriate level of management to correct accumulated misstatements, not correct them himself.]

    c. **Naomi timely communicates all misstatements discovered during the audit, omitting the clearly trivial ones. [This answer is correct. AU-C 450.07 requires the auditor to communicate to management on a timely basis all misstatements accumulated during the audit, other than clearly trivial ones. Thus, Naomi has handled this communication correctly.]**

    d. After James confirms detected misstatements were corrected, he performs no other procedures checking for remaining misstatements. [This answer is incorrect. Following the correction of detected misstatements, James should perform additional procedures to determine whether misstatements still remain.]

DRAFTING THE FINANCIAL STATEMENTS AND THE AUDITOR'S REPORT

Drafting the Financial Statements

In many HUD audit engagements, the auditor drafts or assists with drafting the financial statements. Financial statement preparation assistance is a nonattest service subject to the requirements of ET 1.295 of the AICPA *Code of Professional Conduct*. It is important that management and the project owner understand that the auditor's involvement in drafting the financial statements does not change the fact that management is responsible for the financial statements. As previously discussed, the client is expected to acknowledge its responsibility in the management representation letter. Furthermore, for the auditor to remain independent, among other things, management should agree to accept that responsibility, and the auditor should be satisfied that management has the ability to do so. The auditor's understanding with the client regarding drafting the financial statements should be documented. The auditor needs to discuss the representation letter with management personnel so they understand the meaning and significance of acknowledging responsibility for the financial statements.

***Government Auditing Standards* Requirements.** Because audits of HUD-assisted entities are subject to *Government Auditing Standards*, auditors have to consider the Yellow Book independence standards as well as the AICPA independence standards when determining whether their participation in drafting the financial statements and notes could impair their independence. According to ET 1.295.010.06, activities such as financial statement preparation, cash-to-accrual conversions, and reconciliations are outside the scope of attest engagements and, therefore, are nonattest services that could impair auditors' independence.

It is important to note that the Yellow Book identifies specific nonaudit services that always impair independence and that auditors are prohibited from providing to audited entities. If a nonaudit service is not specifically prohibited, the auditor is required to assess its impact on independence using the Yellow Book's conceptual framework for independence.

The Yellow Book, at Paragraph 3.88, explicitly states that auditors should conclude that preparing financial statements in their entirety from a client-provided trial balance or underlying accounting records creates *significant threats* to the auditor's independence, and auditors should document the threats and safeguards applied to eliminate and reduce threats to an acceptable level or decline to provide services. In addition, Paragraph 3.89 of the Yellow Book indicates that auditors should identify as threats to independence any services related to preparing accounting records and financial statements, other than those defined as impairments to independence in Paragraph 3.87, and significant threats in Paragraph 3.88. Those services include:

- Recording transactions for which management has determined or approved the appropriate account classification, or posting coded transactions to an entity's general ledger.
- Preparing certain line items or financial statement sections based on trial balance information.
- Posting entries to an audited entity's trial balance that have been approved by management.
- Preparing account reconciliations that identify reconciling items for audited entities for evaluation by management.

When threats are identified, auditors must determine whether they are significant. For threats relating to preparing accounting records and financial statements, Paragraph 3.90 of the Yellow Book also requires auditors to document the evaluation of the significance of such threats (in addition to documenting whether the threat is significant). When threats are determined to be significant, auditors must apply safeguards to eliminate or reduce the threats to an acceptable level. Paragraphs 3.93–3.95 provide application guidance about evaluating the significance of threats. Paragraph 3.93 reminds auditors that determining whether services are significant threats and require safeguards is a matter of professional judgment. A flowchart is included as Figure 2 at the end of Chapter 3 of the Yellow Book to illustrate the auditor's consideration of the financial statement preparation threat.

<u>Considerations for Nonprofit Audits.</u> Similar considerations apply when the auditor assists in drafting the schedule of expenditures of federal awards in a Single Audit of a nonprofit HUD-assisted entity. The GAS/SA Audit Guide,

Paragraph 8.01, notes that the Uniform Guidance places the responsibility for preparing the schedule of expenditures of federal awards on the auditee. The authors believe that assisting with its preparation would be considered a nonaudit service that the auditor would need to evaluate using the criteria in the two preceding paragraphs.

Additional Considerations. Management and the HUD project owner need to understand that the auditor's involvement in drafting the financial statements (including the schedule of expenditures of federal awards in a Single Audit) does not change the character of the statements or schedule as management's representations.

Management needs to also understand that the auditor's involvement in drafting the financial statements may represent a significant deficiency or material weakness in internal control that should be communicated, in writing, to management and those charged with governance. Communicating internal control related matters, including issues related to the auditor's involvement in financial statement preparation, are discussed in detail later in this lesson.

Notes to the Financial Statements

The disclosures made in the notes to the financial statements are an integral part of the financial statements. Normally, the information is tested when the related financial statement area is tested.

It can be a problem determining that all of the disclosures required by GAAP are made. The authors recommend the use of disclosure checklists such as those included in *PPC's Guide to HUD Audits*. Those checklists are not GAAP application or presentation checklists, but do include some general guidance on financial statement classification and format that may be useful when preparing or reviewing the financial statements.

Auditor's Reports

Dating the Auditor's Report. GAAS requires that the date of the auditor's report should be no earlier than the date sufficient appropriate audit evidence has been obtained on which to base the opinion on the financial statements. Among other items, sufficient appropriate audit evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements.

The auditor needs to coordinate the following dates:

- Audit report date.
- Management representation letter date.
- Subsequent events evaluation note disclosure date.

In order to coordinate the auditor's report date, management representation letter date, and the subsequent events evaluation note disclosure date, the auditor may want to take the following steps:

- Discuss the dating requirements with management in advance of starting the audit.
- Include in the engagement letter a provision that management will not date the subsequent event note earlier than the date of their management representation letter and the date of the auditor's report.

This process will generally result in the date management discloses as the date through which they have evaluated subsequent events being the same date as the auditor's report.

Report Release Date. AU-C 230.15 requires the auditor to document the report release date in the workpapers. The report release date is the date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most audits of HUD entities, this will be the date that the auditor delivers the report to the client. The report release date should be documented. The auditor may additionally document that date in an engagement summary memorandum, if one is prepared.

Supplementary Information

In a HUD audit, a hard copy of the financial data that HUD-assisted entities are required to submit to HUD electronically through FASSUB is presented with the audited financial statements as supplementary information. The schedule of expenditures of federal awards, required by the Uniform Guidance in audits of nonprofit HUD-assisted entities, is also presented with the entity's audited financial statements as supplementary information. AU-C 725.05 indicates that in order to express an opinion on whether the supplementary information is fairly stated in all material respects in relation to the financial statements as a whole, the auditor should determine that the following conditions were met:

- The supplementary information (a) was derived from and relates directly to the underlying accounting and other records used to prepare the financial statements, (b) relates to the same accounting period as the financial statements, and (c) will accompany the entity's audited financial statements or those audited statements will be made readily available by the entity.
- The financial statements were audited, and the auditor issued a report on those financial statements.
- The auditor did not issue an adverse or disclaimer of opinion on the financial statements.

AU-C 725.06 states that the auditor should obtain management's agreement that it acknowledges and understands its responsibility for the following:

- Preparing the supplementary information in accordance with the applicable criteria.
- Providing the auditor with certain written representations.
- Including the auditor's report on the supplementary information in any document that contains the supplementary information and indicates that the auditor reported on it.
- Presenting the supplementary information with the audited financial statements, or, if the supplementary information will not be presented with the audited financial statements, making the audited financial statements readily available to the intended users of the supplementary information no later than the date the entity issues the supplementary information and auditor's report.

AU-C 725.07 also indicates the auditor should perform the following procedures on supplementary information:

a. Inquire of management about the purpose of the supplementary information and the criteria used to prepare it.

b. Determine whether the form and content of the supplementary information comply with the applicable criteria.

c. Obtain an understanding about the methods used to prepare the supplementary information and determine whether the methods have changed from those used in the prior period and, if so, the reasons for such changes.

d. Compare and reconcile the supplementary information to the financial statements or underlying accounting or other records.

e. Inquire of management about significant assumptions or interpretations underlying the measurement or presentation of the supplementary information.

f. Evaluate the appropriateness and completeness of the supplementary information, considering the results of the procedures performed and other knowledge obtained during the audit of the financial statements.

g. Obtain certain written representations from management about the supplementary information.

According to AU-C 725.13, if the auditor concludes that the supplementary information is materially misstated in relation to the financial statements as a whole, the auditor should discuss the matter with management and propose that the information be revised. If management does not revise the supplementary information, the auditor should either (a) modify the opinion on the supplementary information and describe the misstatement in the auditor's report or, (b) if a separate report is being issued on the supplementary information, withhold the auditor's report on the supplementary information.

AUDITOR'S REPORT PREPARED AS PART OF A COST CERTIFICATION AUDIT OF A HUD-ASSISTED PROJECT

Before the final endorsement of the construction of a HUD-insured or capital advance project, the owner is required to submit audited financial statements reporting the cost of the project to HUD. As previously mentioned, this course does not provide guidance on performing cost certification audits. However, *PPC's Guide to HUD Audits* discusses some important factors to consider when reporting the results of a cost certification audit and includes an illustrative auditor's report. Chapter 5 of the HUD audit guide, "Development Cost Certification Audit Guidance," provides guidance for performing cost certification audits. Auditors also rely on chapter 13 of HUD's guidebook, *Multifamily Accelerated Processing* (the MAP Guide), for guidance on cost certifications.

THE EXIT CONFERENCE AND CLIENT COMMUNICATIONS

Exit Conference

Upon the completion of fieldwork, the auditor typically holds an exit conference with key members of management. In unusual situations, a representative of HUD might also attend the exit conference.

The authors recommend that the following be discussed at the exit conference:

- Complex or unusual accounting principles or other matters in the financial statements, including any unresolved presentation or disclosure issues. (This is necessary so that the client can take responsibility for the financial statements.)
- Draft copies of the auditor's reports, including the reports on compliance and internal controls.
- The client's views concerning the auditor's findings, conclusions, and recommendations, as well as the client's planned corrective actions. (This provides the client with an advance opportunity to discuss whether planned corrective actions adequately address the auditor's recommendations and to initiate the corrective action without waiting for the final audit report.)
- The client's reporting and submission responsibilities, including the client's responsibilities for:
  - Ensuring that the audit is completed within the time requirements set forth in its contracts or agreements with HUD.
  - Electronically submitting required financial and compliance data to HUD; and, for nonprofit entities, submitting the report package to the Federal Audit Clearinghouse.
  - Filing the audit report package (or portions thereof) with the applicable HUD management office electronically or by hardcopy according to the particular program requirements.
  - Providing responses to the auditor's findings and preparing a separate corrective action plan.
  - Providing a schedule of the status of prior audit findings.
- Clarification of the auditor's responsibilities regarding documents for submission and final arrangements for report distribution.
- Other matters the auditor considers significant, such as internal control deficiencies; violations of budget or program requirements; and errors, fraud, noncompliance, or abuse that are not required to be communicated in writing.

Communicating Internal Control Related Matters

AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*, establishes requirements for auditors to communicate certain control deficiencies that they have identified during the audit. Control deficiencies, which, in the auditor's judgment, are *significant deficiencies* or *material weaknesses*, should be communicated in writing to management and those charged with governance. The internal control reporting requirements in *Government Auditing Standards* and the HUD audit guide go beyond what is required in AU-C 265 by requiring the auditor to issue a *report* that discloses significant deficiencies and material weaknesses in internal controls over both financial reporting and compliance based on the audit.

Identifying Control Deficiencies. AU-C 265.08 states that the auditor should determine whether, on the basis of the audit work performed, the auditor has identified one or more deficiencies in internal control. As discussed below, to determine which identified deficiencies in internal control to report, the auditor evaluates them to determine whether the deficiencies, individually or in combination, are significant deficiencies or material weaknesses.

AU-C 265, as amended by AU-C 940, contains the following definitions which apply to evaluating internal control matters identified in the financial statement audit:

- *Deficiency in Internal Control.* A deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. A deficiency in design exists when (a) a control necessary to meet the control objective is missing or (b) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. A deficiency in operation exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.
- *Material Weakness.* A material weakness is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable as defined as follows:
  - *Reasonably possible.* The chance of the future event or events occurring is more than remote but less than likely.
  - *Probable.* The future event or events are likely to occur.
- *Significant Deficiency.* A significant deficiency is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Considerations for the Compliance Audit. The discussion in this section focuses on the guidance provided in AU-C 265. AU-C 265 relates to financial statement audits; thus, the terminology and examples relate to financial reporting matters. In an audit of compliance, the significance of a control deficiency depends on the potential for noncompliance. Auditors may consider the definitions of compliance control deficiencies when identifying and assessing deficiencies in internal control over compliance.

Evaluating Identified Deficiencies. AU-C 265.09 states that the auditor should evaluate each identified deficiency in internal control to determine, on the basis of the audit work performed, whether, individually or in combination, they constitute significant deficiencies or material weaknesses. The auditor should evaluate whether identified control deficiencies are considered to be material weaknesses or significant deficiencies when combined with other deficiencies affecting the same significant class(es) of transactions, significant account balance(s) or disclosure(s), relevant assertion, or component of internal control. To illustrate, assume an auditor considers several control deficiencies in and of themselves insignificant and, thus, only control deficiencies. If those control deficiencies were related, however (for example, they all related to the same account balance), the requirement in AU-C 265 to combine control deficiencies might cause the auditor to consider them a significant deficiency or material weakness.

AU-C 265.10 states that if the auditor determines that a deficiency, or a combination of deficiencies, in internal control is not a material weakness, the auditor should consider whether a prudent official, having knowledge of the same facts and circumstances, would likely reach the same conclusion.

Documenting Control Deficiencies. The auditor should document information about identified control deficiencies such as summarizing and evaluating whether control deficiencies, either individually or in combination, are significant deficiencies or material weaknesses, as well as communications to management and those charged with governance.

Do Clients Automatically Have a Deficiency if the Auditors Prepare the Financial Statements? The auditor's preparation of the financial statements does not automatically indicate that there is a material weakness, significant deficiency, or other control deficiency. Many clients request auditors to prepare, or assist with preparing, the financial statements and related disclosures in a HUD audit. Those services can range from preparing the complete set of financial statements (including the notes and supplementary information) to preparing only one statement (such as the statement of cash flows), to preparing only the notes to the financial statements.

The auditor's preparation of financial statements does not cause a control deficiency; however, it may be the result of a control deficiency. When determining whether a control deficiency exists under AU-C 265, the issue to consider is whether the client has controls in place to prevent, or detect and correct, misstatements in the financial statements.

If auditors prepare financial statements for a client, they should understand and distinguish between their responsibilities to determine whether (a) there is a material weakness or significant deficiency that should be communicated to the client under AU-C 265 and (b) they are independent under the applicable professional standards. (Under ET Section 1.295, the preparation of financial statements is a *nonattest* service; according to the Yellow Book it is a nonaudit service. Before auditors prepare financial statements for their clients, they should determine that the requirements of ET Section 1.295 and the Yellow Book to maintain their independence have been met.)

The auditor's preparation of the financial statements and the related notes does not relieve the client of the responsibility for the statements and for the establishment of controls over the financial reporting process. A revision to ET Section 1.295 deleted from the ethics rules a prohibition against a member "designing or maintaining internal controls" for the client. The deletion of that prohibition enables auditors to maintain controls over financial statement preparation and retain their independence as long as management agrees to (a) accept responsibility for such controls and (b) performs all the requirements of ET Section 1.295 for nonattest services. Determining whether a control deficiency exists and whether it is a significant deficiency or a material weakness is subjective and often may be a difficult judgment call. There are many areas requiring professional judgment in which auditors need to evaluate the facts and circumstances specific to each situation.

The requirements of ET 1.295 include obtaining management's agreement to oversee the financial statement preparation service by designating an individual, preferably within senior management, who possesses suitable skill, knowledge, or experience. Under ET Section 1.295, the individual designated by management should possess the technical skills, knowledge, and experience sufficient to (a) understand the financial statement preparation service enough to be able to provide general direction for the service; (b) understand the key issues the auditor identifies; (c) make any required management decisions; and (d) evaluate the adequacy of, and accept responsibility for, the results of the auditor's work. The auditor considers whether the designated individual fulfills this competency requirement based on factors such as the individual's understanding of the service, knowledge of the client's business and industry, general business knowledge and education, and position within the client. When assessing competency, the relative importance of those factors is considered in relation to the financial statement preparation service being performed.

The Yellow Book, Paragraph 3.77, states that before agreeing to provide a nonaudit service, the auditor should determine whether providing the service would create a threat to independence, either by itself or in the aggregate with other nonaudit services. It requires that nonaudit services that are not specifically prohibited by *Government Auditing Standards* be evaluated in accordance with the Yellow Book's conceptual framework for independence.

Before the auditor concludes he or she can prepare financial statements for an audit client because he or she can meet the independence requirements described in the preceding paragraphs, the auditor also should consider the cumulative effect of performing multiple nonattest services on the threats to independence.

Communication of Identified Deficiencies. AU-C 265.11 states that the auditor should communicate significant deficiencies and material weaknesses identified during the audit in writing to *those charged with governance*.

In addition, AU-C 265.12 states that the auditor also should communicate the following *to management*:

- In writing, significant deficiencies and material weaknesses that the auditor has communicated or intends to communicate to those charged with governance, unless it would be inappropriate to communicate directly to management in the circumstances.
- In writing or orally, other deficiencies in internal control identified during the audit that have not been communicated to management by other parties and that, in the auditor's professional judgment, are of sufficient importance to merit management's attention. If other deficiencies in internal control are communicated orally, the auditor should document the communication.

The fact that the auditor communicated a significant deficiency or material weakness to those charged with governance and management in a previous audit does not eliminate the need for the auditor to repeat the communication in the current year if remedial action has not been taken yet. AU-C 265.A20 states that the auditor may ask management or, when appropriate, those charged with governance, why the significant deficiency or material weakness has not yet been remedied. A failure to act, in the absence of a rational explanation, may in itself represent a significant deficiency or material weakness.

If a previously communicated significant deficiency or material weakness remains, one option is for the auditor to repeat in the current year's written communication the description from the previous communication. In this case, the authors believe there should be an indication that the same comments were made in prior communications. For convenience, such comments may be presented separately from new comments under a heading such as "Significant Deficiencies Communicated in Prior Years." Prior-year comments typically are presented after new comments. The communication may merely refer to the previously-issued communication and its date.

The auditor may orally communicate significant deficiencies and material weaknesses during the audit. These communications need not be in writing at the interim date. AU-C 265 clarifies that the auditor is still required to include such significant deficiencies or material weaknesses, even if they have been remediated, in the written communication at year end.

<u>Timing of the Communications.</u> AU-C 265.13 states that the auditor should make the required communications no later than 60 days following the report release date. (The *report release date* is defined in AU-C 230, *Audit Documentation*, as the date the auditor grants the entity permission to use the auditor's report in connection with the financial statements. In many cases, the report release date will be the date the auditor delivers the report to the client.) Despite the requirement to make these communications no later than 60 days following the report release date, AU-C 265.A16 states that the communication is best made by the report release date because early communication of identified deficiencies may be an important factor in enabling those charged with governance to discharge their oversight responsibilities. Nevertheless, because the auditor's written communication of significant deficiencies and material weaknesses forms part of the final audit file, the written communication is subject to the overriding requirement in AU-C 260.16 for the auditor to complete the assembly of the final audit file on a timely basis, no later than 60 days following the report release date.

<u>No Significant Deficiencies.</u> AU-C 265.16 precludes auditors from issuing a written communication stating that no significant deficiencies were identified during the audit because of the potential for such a communication to be misunderstood or misused. If there are no significant deficiencies, less serious control deficiencies may still exist. AU-C 265.12(b) states that the auditor should communicate, in writing or orally, such other deficiencies in internal control that (a) have not been communicated to management by other parties and (b) are of sufficient importance to merit management's attention in the auditor's professional judgment. In addition, both the Yellow Book and the HUD audit guide have communication requirements for certain audit findings that do not meet the threshold for inclusion in the reports on internal control that are issued in a HUD audit. Accordingly, auditors may want to include the deficiencies in a separate communication, such as a management letter.

<u>No Material Weaknesses.</u> The auditor may be requested to provide a written communication indicating that no material weaknesses were identified during the audit. Such a written communication does not provide any

assurance about the effectiveness of an entity's internal control over financial reporting; however, AU-C 265 does not preclude the auditor from issuing such a communication. (As previously discussed, however, AU-C 265 does preclude the auditor from issuing a written communication stating that no significant deficiencies were identified.) If the auditor agrees to issue a written communication indicating no material weaknesses were identified during the audit, AU-C 265.15 states that the written communication should include the matters required by AU-C 265.14(a), (c), and (d).

Additional Considerations. Both the HUD audit guide and *Government Auditing Standards* require the auditor to issue reports on internal control that disclose significant deficiencies and material weaknesses.

Communication with Those Charged with Governance

In addition to the communication of internal control matters (previously discussed), the communication of fraud or noncompliance (discussed later in this section), and the communication about the entity's ability to continue as a going concern, the auditor should communicate certain matters to those charged with governance. AU-C 260, *The Auditor's Communication With Those Charged With Governance*, establishes requirements and provides guidance on the auditor's communication with the individuals responsible for an entity's governance.

The communication requirements of AU-C 260 apply to all nonpublic entities, regardless of their governance structure or size. However, specific considerations apply if all of those charged with governance are also involved in managing the entity. AU-C 260 does not establish requirements for communication with management unless they are also charged with a governance role.

AU-C 260.06 defines *those charged with governance* as those that have the responsibility to oversee the strategic direction of the entity, and the obligations that relate to the entity's accountability— including oversight of the financial reporting process. Those charged with governance may include an organization or management personnel (such as executive members of a governance board or an owner-manager).

In some HUD entities, the appropriate person(s) with whom to communicate may not be clearly identifiable. In this situation, the auditor and the engaging party need to discuss and agree on who are the appropriate person(s) within the governance structure. Also, if all those charged with governance are involved in managing the business, the auditor should consider whether communication with the person(s) with financial reporting responsibilities adequately informs all of those with whom the auditor would otherwise have to communicate because of their governance role.

The auditor should communicate the following broad categories or matters to those charged with governance:

a. The auditor's responsibilities under generally accepted auditing standards. (AU-C 935.38 clarifies that in a compliance audit, this communication also should include the auditor's responsibilities under *Government Auditing Standards* and the governmental audit requirement, such as the HUD audit guide or the Uniform Guidance.)

b. An overview of the planned scope and timing of the audit.

c. Significant findings from the audit.

d. Uncorrected misstatements.

To help establish the basis of the communication process, the auditor should communicate the form, timing, and expected general content of communications with those charged with governance. Clearly communicating such information helps lay the groundwork for effective two-way communication between the auditor and those charged with governance. It may also benefit effective two-way communication if the auditor:

- Discusses the purpose of communications.

- Identifies the person(s) on the audit team and among those charged with governance who will generally communicate about matters.

- Conveys his or her expectation that communications will be two-way with those charged with governance communicating about matters they consider relevant to the audit.
- Explains the process for taking action and reporting back on matters between the audit team and those charged with governance.

Responsibilities under GAAS. AU-C 260.10 requires communication of the auditor's responsibilities under GAAS, including that (a) the auditor is responsible for forming and expressing an opinion about whether the financial statements are presented fairly in accordance with GAAP and (b) the audit does not relieve management or those charged with governance of their responsibilities. (These responsibilities may be communicated in the engagement letter if the engagement letter is provided to those charged with governance.)

The auditor is also permitted to communicate that:

- The auditor is responsible for performing the audit in accordance with GAAS and that the audit is designed to obtain reasonable, but not absolute, assurance about whether the financial statements are free of material misstatement.
- The audit includes consideration of internal control as a basis for designing audit procedures but not for expressing an opinion on internal control.
- The auditor is responsible for communicating significant audit-related matters that the auditor judges to be relevant to those charged with governance in overseeing the financial reporting process. The auditor is not required to design procedures for the purpose of identifying other matters to communicate.
- The auditor is responsible for communicating specific matters required by law or regulation, by agreement with the entity, or by additional requirements applicable to the engagement.
- The auditor identified matters that, in his or her judgment, may reasonably be thought to bear on independence and to which the auditor gave significant consideration in reaching a conclusion that independence was not impaired.

The types of independence matters that the auditor might determine to be appropriate for communication with those charged with governance include business or family relationships, nonaudit services provided or expected to be provided, or financial interests. The auditor might wish to explain these threats and the safeguards that reduce them to an acceptable level.

Planned Scope and Timing of Audit. AU-C 260.11 requires the auditor to communicate the planned scope and timing of the audit, including significant risks the auditor has identified. However, this communication cannot be so detailed as to compromise the effectiveness of the audit. For example, communicating the nature and timing of detailed audit procedures may make those procedures predictable and compromise their effectiveness. Planning matters to be communicated might include:

- How the auditor plans to address the significant risks of material misstatement due to error or fraud.
- The auditor's approach to internal control, including whether the auditor will express an opinion on the effectiveness of internal control over financial reporting.
- A discussion of materiality as it relates to planning and performing the audit—focusing on factors considered, not on specific amounts or thresholds.
- The extent to which the auditor will use the work of internal auditors, if applicable, and how the internal and external auditors can best work together.

Significant Audit Findings. AU-C 260.12 requires the auditor to communicate significant matters, findings, or issues from the audit, including:

a. *Qualitative Aspects of the Entity's Significant Accounting Practices.* The auditor's views about qualitative aspects of the entity's significant accounting practices, including accounting policies, estimates, and financial statement disclosures. When applicable, the auditor should also—

(1) Explain why a significant accounting practice that is acceptable under GAAP is not considered appropriate in the particular circumstances of the HUD project.

(2) Determine that those charged with governance are informed about the process used by management in developing particularly sensitive accounting estimates, including fair value estimates, and about the basis for the auditor's conclusions regarding the reasonableness of those estimates.

b. *Significant Difficulties Encountered During the Audit.* This right includes restrictions imposed on the auditors by management, significant delays in providing required information, unavailability of evidence, an unnecessarily brief time to complete the audit, extreme and unexpected effort required to obtain audit evidence, or management's unwillingness to provide information about how management plans to deal with a going concern matter. In some circumstances, significant difficulties encountered during the audit may constitute a scope limitation requiring a modified report.

c. Significant unusual transactions.

d. *Disagreements with Management.* Whether or not satisfactorily resolved, differences with management about matters that could individually or in the aggregate be significant to the entity's financial statements or the auditor's report. However, disagreements with management in this context do not include differences of opinion based on incomplete facts or preliminary information that are subsequently resolved.

e. Circumstances affecting the form and content of the auditor's report.

f. Difficult or contentious matters that involved consultation outside the engagement team and are significant and relevant to the responsibilities of those charged with governance for oversight of the financial reporting process.

g. *Other Findings or Issues.* If applicable, other findings or issues that the auditor judges to be significant and relevant to those charged with governance regarding their oversight of the financial reporting process.

h. *Independence.* Circumstances or relationships that in the auditor's professional judgment may reasonably be thought to bear on independence. (AU-C 260 does not mandate this communication, but AU-C 260.A15 states the auditor "may determine" it is appropriate.)

Uncorrected Misstatements. AU-C 260.13 requires the auditor to communicate uncorrected misstatements (other than those considered to be trivial), including the effect they might have on the auditor's opinion, to those charged with governance. The auditor should discuss material uncorrected misstatements individually and request that they be corrected. (If there are a large number of individually immaterial uncorrected misstatements, the auditor may summarize them and communicate the number and overall monetary effect on the financial statements.) The auditor should discuss the implications of not correcting known and likely misstatements and explain that uncorrected misstatements or underlying matters could cause financial statements of future periods to be misstated even if immaterial to the financial statements under audit. The auditor also needs to communicate the effect of prior period uncorrected misstatements on classes of transactions, account balances or disclosures, and on the financial statements taken as a whole.

When All Those Charged with Governance Are Not Involved in Management. Unless all those charged with governance are also involved in managing the entity, the auditor is also required to communicate the following:

a. *Material Corrected Misstatements.* Misstatements brought to the attention of management as a result of auditing procedures.

b. *Written Representations Requested from Management.* This may be done by providing a copy of the written representations obtained from management.

c. *Management's Consultations with Other Accountants.* The auditor's views about significant accounting or auditing matters that were the subject of management consultation with other accountants.

d. *Significant Issues Discussed, or Subject to Correspondence, with Management.* Issues such as application of accounting principles and auditing standards; and business conditions, plans or strategies that may affect the risks of material misstatement.

AU-C 260.16 indicates the significant audit findings should be communicated in writing when the auditor believes that oral communication would not be adequate. When the communication is in writing, according to AU-C 260.18, the auditor should indicate that it is intended solely for the information and use of those charged with governance and, if appropriate, management, and is not intended to be and should not be used by anyone other than these specified parties. AU-C 260.19 states that the communication should be on a sufficiently timely basis to permit appropriate action. The auditor should evaluate whether the two-way communication process with those charged with governance is adequate according to AU-C 260.20, and, if it is not, consider the effects of the risks of material misstatements and the sufficiency and appropriateness of the audit evidence supporting the auditor's opinion. AU-C 260 does not change the communication requirements of other AU-Cs.

Documentation of Communications. AU-C 260.21 requires the auditor to document matters that have been communicated orally. This documentation may include a copy of minutes prepared by the entity. When matters have been communicated in writing, the auditor should retain a copy of the communication. The engagement letter may be used to communicate planning matters, including the auditor's responsibilities under GAAS and the planned scope and timing of the audit, as long as the letter is provided to those charged with governance. Significant findings near the conclusion of the audit should also be communicated and documented.

Communication of Violations of Laws and Regulations, and Fraud

The auditor's responsibility to evaluate the results of audit procedures and consider whether they lead the auditor to believe that an error or fraud may have occurred was discussed earlier in this lesson. AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, imposes detection and communication responsibilities for violations of laws and regulations (previously referred to as *illegal acts*) that have a *direct and material* effect on the determination of financial statement amounts. AU-C 250 imposes lesser responsibilities for *detection* of violations of laws or regulations having *material but indirect* effects on the determination of financial statement amounts (primarily inquiry and inspection of any relevant correspondence) and establishes communication responsibilities for those violations. The auditor's responsibility to evaluate the results of audit procedures and consider whether they lead the auditor to believe that an error or fraud may have occurred was also discussed earlier. Information on the auditor's detection responsibilities under AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, related to misstatements caused by fraud, can be found in *PPC's Guide to HUD Audits*.

Under AU-C 250 and AU-C 240, the auditor ordinarily is not responsible for disclosing violations of laws and regulations or fraud to parties other than senior management and those charged with governance. However, GAAS specifically recognizes the auditor's duty to disclose such matters to a funding agency or other specified agency in accordance with governmental audit requirements—such as the HUD audit guide, *Government Auditing Standards*, and the Uniform Guidance.

Communication to Those Charged with Governance. AU-C 250.21 requires that the auditor ensure that those charged with governance are adequately informed about any violations of laws or regulations, unless clearly inconsequential, that come to the auditor's attention. As previously discussed, if the auditor determines there is evidence fraud may exist (even if the matter is inconsequential) AU-C 240.39 requires the auditor to report it to the appropriate level of management. If the fraud or potential fraud involves senior management or causes the financial statements to be materially misstated, it should be reported directly to those charged with governance. AU-C 240.A70 indicates that auditors may consider it appropriate to communicate with those charged with governance about misappropriations committed by lower-level employees that do not result in a material misstatement. Auditors also normally reach an understanding with those charged with governance about those misappropriations committed by lower-level employees. In the absence of such an agreement, the authors believe the auditor needs to report all instances of fraud to both the appropriate level of management and to those charged with governance. The authors recommend that communications about possible fraud be made in writing; if made orally, the nature of the communication should be documented in the workpapers.

FINALIZATION AND RETENTION OF WORKPAPERS

After the auditor issues the audit report, professional standards require that the workpapers be completed on a timely basis.

Documentation Completion Date

SQCS No. 8 (QM 10A.49) requires firms to establish policies and procedures that require final engagement files to be assembled on a timely basis after the reports have been released. Those policies and procedures need to comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. Professional standards require workpapers to be completed on a timely basis (AU-C 230.07). In addition, the final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to this date as the *documentation completion date*. After this date, the auditor should not delete or discard any documentation prior to the expiration of the specified retention period discussed below. Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's system of quality control. In addition, auditors need to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

AU-C 230.A26 indicates that at any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as to—

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor's report, including discarding to-do lists and superseded drafts, correcting typographical errors, and changing notes that reflect incomplete or preliminary thinking.
- Insert information that was received after the date of the auditor's report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that changes to the workpapers after the date of the auditor's report and prior to the documentation completion date constitute those that are part of the "wrap-up" or workpaper filing process. The auditor would not be adding or changing information after the date of the auditor's report that was necessary to support the opinion on the financial statements. That is, the auditor should not make changes after the report date that would have impacted the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

Workpaper Retention

Auditors should establish quality control policies and procedures regarding the retention of workpapers. These policies should be for a time frame that meets the needs of the auditor's practice and considers any regulatory or legal requirements regarding document retention. AU-C 230.17 specifically requires that this period not be shorter than five years from the report release date. In addition, the procedures adopted need to enable the auditor to access electronic workpapers throughout the retention period. The Yellow Book, at Paragraph 5.46, states that the auditors' policies and procedures for retention of engagement documentation should be the greater of the period required by regulation and law or the period of time adequate to permit those performing peer review and monitoring procedures of the auditor to evaluate the auditors' system of quality control compliance.

HUD Audit Guide Requirements. Paragraph 1-5(E) of the HUD audit guide requires that audit documentation of for-profit HUD entities be retained for at least six years after the audit report is submitted to HUD, unless HUD or the Government Accountability Office (GAO) notifies the auditor in writing to extend the retention period.

Single Audit Requirements, Applicable for Nonprofit Audits. Section 200.517(a) of the Uniform Guidance states that the auditor must keep Single Audit workpapers for at least three years after the date of issuance of the auditor's report(s) to the auditee. In addition, Section 200.517(a) states that the auditor is required to maintain the audit documentation for a longer period if the auditor is notified in writing by the cognizant or oversight agency for audit, or pass-through entity to extend the retention period. Accordingly, the authors believe auditors would maintain audit documentation at least six years for a Single Audit of a HUD-assisted entity to comply with the requirement in the previous paragraph.

Contested Findings and Access. If the auditor becomes aware that any party is contesting an audit finding reported by the auditor, the auditor must seek guidance from the appropriate parties before audit documentation is destroyed. Paragraph 1-5(A) of the HUD audit guide requires the auditor to provide HUD, the HUD IG, and the GAO (or their representatives) access to hard copy or electronic audit documentation or any other documents needed to review the audit. Access includes making any necessary photocopies of hard copy documentation or other documents or electronic copies of electronic audit documentation. Similar requirements apply for Single Audits of nonprofit HUD entities.

SUBSEQUENT DISCOVERY AFTER THE REPORT DATE

Subsequent to the date of the auditor's report, the auditor may become aware of facts that existed on that date that might have caused him to believe information supplied by the entity was incorrect, incomplete, or otherwise unsatisfactory had he then been aware of them. In such circumstances, the auditor should consider the guidance in AU-C 560, *Subsequent Events and Subsequently Discovered Facts*, in determining an appropriate course of action. Subsequent to the date of the auditor's report, the auditor may also conclude that certain necessary auditing procedures were omitted from the audit, but there is no indication that the financial statements are materially misstated. AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*, provides guidance in that situation. AU-C 935 makes these requirements applicable to a compliance audit.

Subsequent Discovery of Facts Existing at the Date of the Report

AU-C 560 contains separate requirements for situations where facts are discovered before the report release date and those situations where facts are discovered after the report release date. According to AU-C 560.A18, the guidance is applicable even if the auditor has withdrawn or been discharged.

PPC's Guide to Audits of Nonpublic Companies provides guidance on the auditor's considerations regarding subsequently discovered facts. *PPC's Guide to Auditor's Reports* provides reporting guidance when the decision is made to issue revised financial statements and auditor's report.

Consideration of Omitted Procedures

According to AU-C 585.06, when the auditor determines that certain necessary auditing procedures were omitted, the auditor should assess the importance of the omitted procedures on his ability to support his previous opinions and reports. Review of the workpapers, discussions with others assigned to the engagement, and reevaluation of the overall audit scope may be helpful in making the assessment. The results of subsequent audits also may be considered.

If the auditor concludes that the auditor is unable to support the auditor's previous opinions and reports, and there are persons currently relying on, or likely to rely on, the report, the auditor should promptly apply the omitted procedures or alternative procedures that would support the opinion. After applying the procedures, if the auditor becomes aware of facts existing at the date of his report that would have affected the report had the auditor then been aware of them, the auditor should follow the guidance of AU-C 560 for subsequently discovered facts. If the auditor is unable to apply the omitted or alternative procedures, he may decide to consult with his attorney to determine an appropriate course of action.

If performing the omitted procedures necessitates changing workpapers that have previously been finalized, auditors should document the following information:

- When the change was made and reviewed.
- Who made and reviewed the change.

- The reasons for the change.
- The procedures performed, audit evidence obtained, and conclusions reached and their effect on the auditor's report.

The auditor cannot, however, delete or discard any audit documentation after the documentation completion date and through the retention date.

Because of the potential legal implications of a determination that necessary audit procedures have been omitted or that the audit report or audited financial statements were materially inaccurate, auditors may decide to consult their attorneys any time the circumstances described in this section are encountered.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

20. Which of the following indicates that sufficient appropriate audit evidence has been obtained when dating the auditor's report?

    a. The auditor has taken responsibility for the financial statements.

    b. Audit work has commenced for the engagement.

    c. The dating requirements have been discussed with management.

    d. The financial statements and disclosures have been prepared.

21. What exists if the design or operation of a control makes it impossible for management or employees to prevent, or detect and correct, misstatements in a timely fashion while performing their assigned functions?

    a. A deficiency in design.

    b. A deficiency in internal control.

    c. A significant deficiency.

    d. A material weakness.

22. Per AU-C 260, which of the following statements is correct regarding the communications an auditor makes to those charged with governance?

    a. Communications should include such matters as significant findings and uncorrected misstatements.

    b. If those charged with governance also manage the entity, no communications are required.

    c. In HUD entities, the proper individuals with whom to communicate are easy to identify.

    d. The communication requirements are only applicable to nonpublic entities of a certain size.

23. After what date is the auditor no longer allowed to make administrative changes to the workpapers, such as routine file assembly procedures?

    a. The date the auditor's report is initially drafted.

    b. The documentation completion date.

    c. The report release date.

    d. The date communications are made to those charged with governance.

24. What length of time should workpapers from the audit of a for-profit HUD-assisted entity be retained?

    a. Three years.

    b. Five years.

    c. Six years.

    d. Ten years.

SELF STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

20. Which of the following indicates that sufficient appropriate audit evidence has been obtained when dating the auditor's report? **(Page 93)**

    a. The auditor has taken responsibility for the financial statements. [This answer is incorrect. Under GAAS, management must take responsibility for the financial statements, not the auditor.]

    b. Audit work has commenced for the engagement. [This answer is incorrect. For sufficient appropriate audit evidence to exist, audit work must have been reviewed, not merely started.]

    c. The dating requirements have been discussed with management. [This answer is incorrect. In order to coordinate the auditor's report date, management representation letter date, and the subsequent events evaluation note disclosure date, the auditor may want to discuss the dating requirements with management in advance of starting the audit. However, this is a separate consideration than that of whether sufficient appropriate audit evidence exists.]

    d. **The financial statements and disclosures have been prepared. [This answer is correct. GAAS requires that the date of the auditor's report should be no earlier than the date sufficient appropriate audit evidence has been obtained on which to base the opinion on the financial statements. Among other items, sufficient appropriate audit evidence includes evidence that the financial statements, including disclosures, have been prepared.]**

21. What exists if the design or operation of a control makes it impossible for management or employees to prevent, or detect and correct, misstatements in a timely fashion while performing their assigned functions? **(Page 96)**

    a. A deficiency in design. [This answer is incorrect. This exists when (1) a control necessary to meet the control objective is missing or (2) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met. While the issue described above encompasses deficiencies in design, there is a better, more complete, answer choice.]

    b. **A deficiency in internal control. [This answer is correct. As described in AU-C 265, as amended by AU-C 940, a deficiency in internal control over financial reporting exists when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis.]**

    c. A significant deficiency. [This answer is incorrect. This is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention from those charged with governance.]

    d. A material weakness. [This answer is incorrect. This is a deficiency, or combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. This is more severe than the issue described above.]

22. Per AU-C 260, which of the following statements is correct regarding the communications an auditor makes to those charged with governance? **(Page 99)**

    a. **Communications should include such matters as significant findings and uncorrected misstatements. [This answer is correct. The auditor should communicate the following broad categories or matters to those charged with governance: (1) the auditor's responsibilities under GAAS, (2) an overview of the planned scope and timing of the audit, (3) significant findings from the audit, and (4) uncorrected misstatements.]**

b. If those charged with governance also manage the entity, no communications are required. [This answer is incorrect. AU-C 260 does not establish requirements for communication with management unless they are also charged with a governance role, but specific considerations do apply if all of those charged with governance are also involved in managing the entity. The fact that those charged with governance and management may be the same individuals, however, would not eliminate communication requirements.]

c. In HUD entities, the proper individuals with whom to communicate are easy to identify. [This answer is incorrect. In some HUD entities, the appropriate person(s) with whom to communicate may not be clearly identifiable. In this situation, the auditor and the engaging party need to discuss and agree on who are the appropriate person(s) within the governance structure.]

d. The communication requirements are only applicable to nonpublic entities of a certain size. [This answer is incorrect. The communication requirements of AU-C 260 apply to all nonpublic entities, regardless of their governance structure or size.]

23. After what date is the auditor no longer allowed to make administrative changes to the workpapers, such as routine file assembly procedures? **(Page 103)**

a. The date the auditor's report is initially drafted. [This answer is incorrect. As discussed in AU-C 230.A26, the auditor can still make such administrative changes after the report is initially drafted since the original draft may be superseded.]

b. **The documentation completion date. [This answer is correct. AU-C 230.A26 indicates that at any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature, such as to perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.]**

c. The report release date. [This answer is incorrect. The auditor is still able to make such changes after the report release date, per AU-C 230.A26. Generally, final assembly and completion of the audit file should occur within 60 days of the report release date.]

d. The date communications are made to those charged with governance. [This answer is incorrect. This date is not mentioned in AU-C 230.A26 in relation to making changes to the workpapers; thus, a different answer is required.]

24. What length of time should workpapers from the audit of a for-profit HUD-assisted entity be retained? **(Page 103)**

a. Three years. [This answer is incorrect. The Uniform Guidance states that the auditor must keep Single Audit workpapers for at least three years after the date of issuance of the auditor's report(s) to the auditee in a nonprofit audit. However, different guidance applies to for-profit HUD entities.]

b. Five years. [This answer is incorrect. Policies for workpaper retention should be for a time frame that meets the needs of the auditor's practice and considers any regulatory or legal requirements regarding document retention. AU-C 230.17 specifically requires that this period not be shorter than five years from the report release date. However, for-profit HUD-assisted entities must meet a more specific requirement.]

c. **Six years. [This answer is correct. The HUD audit guide requires that audit documentation of for-profit HUD entities be retained for at least six years after the audit report is submitted to HUD (unless HUD or the GAO notifies the auditor in writing to extend the retention period).]**

d. Ten years. [This answer is incorrect. Specific guidance in the HUD audit guide outlines how long workpapers must be retained after a for-profit HUD audit. The period of time specified in the audit guide is less than ten years.]

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to HUD Audits—Course 1—HUD Basics and Concluding a HUD Audit (HUDTG221)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to those questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, fax, or mail your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet**, **Self-study Course Evaluation**, and payment via one of the following methods:

   - Email to *CPLGrading@thomsonreuters.com*
   - Fax to **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     HUDTG221 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2023**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to HUD Audits—Course 1—HUD Basics and Concluding a HUD Audit (HUDTG221)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. Which of the following is one of the broad categories of HUD multifamily housing programs?

   a. Mortgage insurance.

   b. Uninsured loans.

   c. Profit-sharing programs.

   d. Paycheck subsidies.

2. Since HUD programs are established by housing legislation, what identifier is used to categorize many of HUD's programs?

   a. Paragraph.

   b. Chapter.

   c. Section.

   d. Volume.

3. Under HUD's insured loans program, which of the following parties does HUD insure against loss due to a mortgage default?

   a. The borrower.

   b. The tenant.

   c. The builder.

   d. The lender.

4. Which of the following authorizes the largest of HUD's rent subsidy programs?

   a. Section 8.

   b. Section 202.

   c. Section 542.

   d. Section 811.

5. Which of the following ownership types possess approximately 70 percent of multifamily housing projects?

   a. Not-for-profit corporations.

   b. Noncorporate entities.

   c. C corporations.

   d. S corporations.

6. HUD project owners can be organized into three broad categories based on whether they are permitted to retain surplus cash. Which of the following choices correctly identifies those categories?

   a. Corporate entities, elderly or disabled persons, and lenders.

   b. Profit motivated, limited distribution, and nonprofit.

   c. Officers, mortgagors, and banks.

   d. Freddie Mac, Fannie Mae, and the Federal Housing Authority.

7. In what order are the AU-C sections organized within the professional standards?

   a. Preface, AU-C Sections, Glossary, Appendixes.

   b. Glossary, Preface, AU-C Sections, Appendixes.

   c. Preface, Glossary, AU-C Sections, Appendixes.

   d. Preface, Glossary, Appendixes, AU-C Sections.

8. Are for-profit HUD-assisted entities required to comply with the HUD Audit Guide issued by the Office of Inspector General (OIG)?

   a. Yes, if the entity is for-profit it must comply with the HUD Audit Guide.

   b. Yes, because the HUD Audit Guide overrides GAAS and GAGAS.

   c. No, compliance with GAAS and GAGAS is sufficient.

   d. No, the HUD Audit Guide contains for-profit recommendations but is not required.

9. The HUD Handbook 4370.2 REV-1 states that owners of HUD-assisted projects should use which of the following methods when selecting an auditor?

   a. Competitive bidding.

   b. First available auditor.

   c. Closest auditor to the project location.

   d. An auditor personally referred to the owner.

10. Which of the following statements best describes the audit process?

    a. It is a sequential process and information should be analyzed one time at the beginning.

    b. It is a linear process and thus required procedures may not be performed concurrently with other procedures.

    c. The audit process is designed so that risks should be evaluated one time during the engagement.

    d. It is a continuous process of gathering, updating, and analyzing financial statement information.

11. What type of letter asks the client's lawyer to provide information concerning pending or threatened litigation?

    a. The engagement letter.

    b. The legal representation letter.

    c. The management representation letter.

    d. The confirmation letter.

12. During an audit engagement, what might cause a scope limitation that could preclude an unmodified opinion?

    a. Statements in a lawyer's response that emphasize retention of attorney-client and attorney work product privileges.

    b. Refusal by external legal counsel to provide information requested about litigation.

    c. A HUD-assisted entity audit client being subject to environmental remediation liabilities.

    d. Including disclosures about risks and uncertainties related to the nature of operations.

13. Which of the following is accurate regarding accounting estimates and fair value?

    a. The allowance for doubtful accounts accounting estimate is irrelevant to HUD-assisted entities.

    b. Accounting estimates must be recognized in the body of the financial statements.

    c. A fair value measurement is a type of accounting estimate.

    d. Fair value accounting estimates are never required for HUD-assisted entities.

14. Per examples provided in AU-C 540A.A47, which of the following would most likely be an accounting estimate with a high estimation uncertainty?

    a. A fair value accounting estimate using an entity-developed, specialized model.

    b. An estimate calculated using accepted measurement techniques.

    c. A similar estimate in the prior period had substantially the same actual outcome.

    d. An estimate highly dependent on facts and that requires little judgment.

15. According to FASB ASC 855-10-20, a *recognized subsequent event* provides evidence about which of the following?

    a. Conditions that were discovered during the acceptance/continuance process.

    b. Conditions that existed at the date of the balance sheet.

    c. Conditions that arose after financial statements were issued but prior to the next audit.

    d. Conditions that arose after the date of the auditor's report.

16. According to AU-C 935.25, subsequent events procedures related to a compliance audit should be performed up until what date?

    a. The date of the auditor's report.

    b. The year-end date of the client.

    c. No subsequent events procedures need to be considered for compliance audits.

    d. The date audit fieldwork is completed.

17. When the HUD regulations refer to "identities-of-interest," they are referring to which of the following?

    a. Any reporting entity.

    b. The engagement partners.

    c. Members of those charged with governance.

    d. Certain related parties.

18. What effect do related-party transactions have on audit procedures?

    a. Audit procedures for related-party relationships are performed at the end of the engagement, but seldom at the beginning or in the middle.

    b. Different audit procedures are needed for material related-party transactions than those that are used for other significant transactions.

    c. If significant unusual related-party transactions are discovered during the engagement, the auditor must alert HUD.

    d. Final review procedures should look for undisclosed related-party transactions and evaluate the adequacy of disclosure for those that were identified.

19. FASB ASC 205-40 provides guidance about which of the following?

    a. Unidentified or undisclosed related-party relationships or transactions.

    b. The types of subsequent events the auditor should evaluate.

    c. Management's responsibility for evaluating the entity's ability to continue as a going concern.

    d. The requirement for auditors to request written representations from management.

20. Which of the following is an auditor's objective under AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*?

    a. To evaluate possible effects of going concern disclosures on the financial statements.

    b. To issue a management report in accordance with accounting principles.

    c. To conclude that the entity will continue as a going concern for five years.

    d. To ensure the auditor assumes responsibility for all going concern issues.

21. What responsibility does the auditor have for events or conditions beyond the management evaluation period that could affect the entity's ability to continue as a going concern?

    a. The auditor should make inquiries of management about the existence of any such conditions or events.

    b. The auditor only needs to make inquiries if management states in the representation letter that they know of any conditions or events.

    c. The auditor has no responsibility for making inquiries about conditions or events since they are beyond the evaluation period.

    d. The auditor is required to perform other audit procedures to determine if any such conditions or events exist.

22. Redwood Center is a for-profit HUD-assisted entity. Per the HUD Audit Guide, which of the following written representations is Redwood's auditor required to obtain?

    a. Only compliance violations or issues that are material.

    b. Every compliance violation or issue, regardless of its materiality.

    c. The auditor's responsibility to establish effective control over financial reporting.

    d. The HUD Audit Guide does not specify any matters requiring written representation.

23. Who should sign a HUD-assisted entity's management representation letter?

    a. The audit firm's outside legal counsel.

    b. The accounting firm that prepares the monthly financials.

    c. The audit partner assigned to the entity's annual audit.

    d. The entity's current CEO and controller.

24. By what point must the auditor physically possess management's signed representation letter?

    a. Before the acceptance/continuance decision.

    b. Before work on the audit begins.

    c. Before the date of the auditor's report.

    d. Before releasing the auditor's report.

25. How much reliance can an auditor place on management's written representations as audit evidence?

    a. Written representations provide sufficient audit evidence on their own.

    b. Obtaining written representations affects the nature, timing, and extent of audit procedures.

    c. Written representations provide audit evidence, but they are not sufficient on their own.

    d. Obtaining written representations is not necessary for the auditor to express an opinion.

26. How should an auditor handle an identified error or an instance of fraud?

    a. The auditor will need to consider how it affects the assessed risks of material misstatement.

    b. The auditor is required to handle the matter as if it is an isolated, one-time occurrence.

    c. The auditor cannot modify planned procedures even if a large, unexpected misstatement is detected.

    d. The auditor should only consider audit evidence that does not contradict relevant assertions.

27. Julie is hired to audit a nonprofit, HUD-assisted entity. What should she do in relation to evaluating the existence of fraud?

    a. She should only assess the risks of noncompliance due to fraud while obtaining an understanding of internal control.

    b. She should assess the risk that fraud could allow for material noncompliance with HUD requirements.

    c. She should include findings of fraud in publicly available reports prior to reporting it to management.

    d. She should withdraw from the audit if she suspects documents have been altered.

28. In which situation would an auditor be most likely to use a *flux analysis*?

    a. When evaluating significant accounting principles for bias.

    b. When performing a supervisory review.

    c. When evaluating the existence of fraud.

    d. When documenting analytical procedures.

29. Near the conclusion of the engagement, how many times should an audit firm review its workpapers?

    a. One time—a detailed review of audit work.

    b. One time—a supervisory review.

    c. Two times—a detailed review and a supervisory review.

    d. Three times—a detailed review, a supervisory review, and a third-party review.

30. Which of the following is a consideration when a smaller firm identifies an engagement that requires an engagement quality control review?

    a. The firm must use an individual from within the firm, even if he or she does not have the technical qualifications.

    b. The firm is required to hire a qualified individual to become an employee in order to perform the review.

    c. The firm will not be able to perform the review and will have to cease work on the engagement.

    d. The firm may contract with a qualified external individual to perform the review.

31. A misstatement about which there can be no doubt is called what?

    a. A projected misstatement.

    b. A factual misstatement.

    c. A judgmental misstatement.

    d. An accumulated misstatement.

32. When performing an audit of Holden Homes, a for-profit HUD entity, Bobbie discovers information that leads her to withdraw from the engagement. Which of the following actions is she required to take specifically due to Holden's for-profit status?

    a. Notify the HUD servicing program office over the phone.

    b. Notify the HUD OIG single audit coordinator and servicing program office in writing.

    c. Report the circumstances to a third party, such as the media.

    d. Consult with independent legal counsel about starting her own investigation.

33. Which independence standards must be consulted before an auditor can participate in drafting the financial statements of a HUD-assisted entity?

    a. AICPA and Yellow Book independence standards.

    b. Yellow Book and HUD independence standards.

    c. AICPA and HUD independence standards.

    d. AICPA independence standards only.

34. The *report release date* is the date that which of the following occurs?

    a. The auditor has drafted the financial statements.

    b. Management has provided the representation letter.

    c. The client has been given permission to use the auditor's report.

    d. Supplementary information has been submitted to HUD.

35. Which of the following statements is correct regarding supplementary information in audits of HUD-assisted entities?

    a. Auditors must acknowledge their responsibility for preparing supplementary information.

    b. Supplementary information may relate to a different accounting period than the financial statements.

    c. The auditor is not allowed to express an opinion on whether supplementary information is fairly stated.

    d. A hard copy of financial data required to be submitted to HUD is presented as supplementary information.

36. In a HUD audit, when is the exit conference typically held?

    a. When required by HUD.

    b. When the audit report is released.

    c. When fieldwork is complete.

    d. When audit planning commences.

37. Does a control deficiency arise if the auditor assists in preparing a HUD-assisted entity's financial statements?

    a. Yes, having the auditor help prepare the financial statements is an automatic control deficiency in any type of audit.

    b. Yes, and the auditor's assistance in preparing the financial statements also automatically results in a material weakness.

    c. No, having the auditor help prepare the financial statements does not cause a control deficiency, but it may be the result of one.

    d. No, because the auditor is allowed to assume that the client has controls in place to prevent such a deficiency.

38. According to AU-C 265.13, the auditor should make the required communication of identified deficiencies within what time period?

    a. No later than 60 days after the report release date.

    b. No later than 120 days after the report release date.

    c. After past deficiencies have been remediated.

    d. As soon as the fieldwork is complete.

39. When should final completion and assembly of the audit file occur?

    a. No later than the last day of fieldwork.

    b. Prior to the end of the required retention period.

    c. Prior to commencement of the next audit.

    d. Within 60 days of the report release date.

40. If the discovery of matters after the date of the auditor's report leads the auditor to believe necessary auditing procedures were omitted, what is the first action the auditor should take?

    a. Perform a subsequent audit to add the omitted procedures.

    b. Assess the importance of the omitted procedures.

    c. Report the omitted procedures to an attorney.

    d. Discuss the omitted procedures with HUD.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to HUD Audits—Course 1—HUD Basics and Concluding a HUD Audit (HUDTG221)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

City: ______________________________ State/ZIP: ______________

Firm Phone: ______________________________ Firm Fax No.: ______________

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You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Course Title: Companion to PPC's Guide to HUD Audits—Course 1—HUD Basics and Concluding a HUD Audit (HUDTG221)

Your Name (optional): ______________________ Date: ______________

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Please indicate your answers by filling in the appropriate circle as shown:
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Satisfaction Level:	**1**	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**
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1. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
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GLOSSARY

Accounting estimates: Financial statement items that cannot be measured precisely but can only be estimated, such as fair value measurements. Accounting estimates may be recognized in the body of the financial statements or only disclosed in the notes.

Audit differences: Any differences noted between the accounting records and the evidence obtained during the audit, such as a passed adjustment for a specifically identified misstatement or a projected misstatement from a substantive audit sampling application.

Clearly trivial misstatements: Misstatements of reported amounts that are of a wholly smaller order of magnitude than those determined to be immaterial and are clearly inconsequential, individually or in the aggregate, measured against any criteria of size, nature, or circumstance.

Deficiency in design: This exists when (1) a control necessary to meet the control objective is missing or (2) an existing control is not properly designed so that, even if the control operates as designed, the control objective would not be met.

Deficiency in internal control over financial reporting: These exist when the design or operation of a control does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, misstatements on a timely basis. These are made up of deficiencies in design and deficiencies in operation.

Deficiency in operation: This exists when a properly designed control does not operate as designed or when the person performing the control does not possess the necessary authority or competence to perform the control effectively.

Documentation completion date: The date of the final assembly and completion of the audit file. It should be within 60 days of the report release date. After the document completion date, the auditor should not delete or discard any documentation prior to the end of the required retention period.

Factual misstatement: A misstatement about which there is no doubt.

Flux analysis: This is a narrative explanation by financial statement caption (line item) of the change in the amount from the prior period and of any unusual or unexpected relationships to other financial statement line items in the current period.

HUD audit guide: In addition to GAAS and GAGAS, audits of for-profit HUD-assisted entities also must comply with the HUD audit guide issued by the HUD Office of Inspector General.

HUD multifamily housing programs: Part of HUD's broad range of programs designed to revitalize urban neighborhoods, stimulate housing construction, encourage home ownership opportunities, and provide decent, safe, and affordable housing. They can be classified into the categories of (1) multifamily mortgage insurance, (2) coinsured loans, (3) risk-sharing programs, (4) direct loans, capital advances, flexible subsidies, and grants, and (5) rental subsidies.

Judgmental misstatement: A misstatement that arises from judgments made by management including differences related to recognition, measurement, presentation, and disclosure that are considered unreasonable or inappropriate by the auditor.

Legal representation letter: A letter from the client (with the auditor controlling mailing the letter) asking the lawyer to provide or corroborate information about pending or threatened litigation.

Material weakness: This is a deficiency, or a combination of deficiencies, in internal control over financial reporting, such that there is a reasonable possibility that a material misstatement of the entity's financial statements will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable.

Nonrecognized subsequent event: An event that provides evidence about conditions that did not exist at the date of the balance sheet but arose subsequent to that date but before the financial statements are available to be issued.

Office of the Inspector General (OIG): The HUD department responsible for promoting the integrity, efficiency, and effectiveness of HUD programs.

Projected misstatement: A type of misstatement that results from the auditor's best estimate of misstatement extrapolated to entire populations from the use of sampling procedures.

Recognized subsequent event: An event or transaction that provides additional evidence about conditions that existed at the date of the balance sheet, including the estimates inherent in the process of preparing financial statements.

Report release date: The date that the auditor gives the client permission to use the auditor's report in connection with the financial statements. For most HUD audits, this is the date that the auditor delivers the report to the client.

Significant deficiency: This is a deficiency, or a combination of deficiencies, in internal control over financial reporting that is less severe than a material weakness, yet important enough to merit attention by those charged with governance.

Surplus cash: A regulatory term that essentially refers to cash in excess of that needed to meet all project expenses and reserve requirements.

Those charged with governance: Those that have the responsibility to oversee the strategic direction of the entity and the obligations that relate to the entity's accountability—including oversight of the financial reporting process.

Yellow Book: The name often used for Government Auditing Standards. The Yellow Book standards relate to scope and quality of audit efforts and to the characteristics of a professional and meaningful audit report.

INDEX

This index is a list of general topics discussed in the course. More specific key word searches can be performed using the search feature of this PDF.

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COMPANION TO PPC'S GUIDE TO HUD AUDITS

COURSE 2

COMPLIANCE AUDITING (HUDTG222)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course looks at issues related to compliance auditing for HUD entities. Lesson 1 discusses the authoritative literature that applies to this type of audit; the current compliance environment; and the responsibility for laws, regulations, and other matters that affect this type of engagement. Lesson 2 takes a look at issues related to compliance requirements, including identifying such requirements and auditing compliance with them. Finally, Lesson 3 covers reporting and auditing issues in this type of engagement, such as reporting on compliance and audit sampling.
PUBLICATION/ REVISION DATE:	November 2022
RECOMMENDED FOR:	Users of *PPC's Guide to HUD Audits*
PREREQUISITE/ ADVANCE PREPARATION:	Detailed knowledge of governmental auditing
CPE CREDIT:	8 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's *Government Auditing Standards*.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by **November 30, 2023**
KNOWLEDGE LEVEL:	Intermediate

Learning Objectives:

Lesson 1—Authoritative Literature; the Current Compliance Environment; and Responsibility for Laws, Regulations, and Other Matters

Completion of this lesson will enable you to:
- Identify important aspects of authoritative literature that applies to HUD compliance audits and the current compliance environment.
- Determine the auditor's responsibility for laws, regulations and other matters in a HUD compliance audit.

Lesson 2—Compliance Requirements and Related Considerations

Completion of this lesson will enable you to:
- Identify compliance requirements that apply to a HUD-assisted entity and considerations of internal control over compliance.
- Recognize best practices for auditing a HUD-assisted entity's compliance with the compliance requirements, specific compliance requirements that apply to for-profit HUD-assisted projects, and summarizing and evaluating results of compliance tests.

Lesson 3—Reporting and Auditing Considerations

Completion of this lesson will enable you to:
- Recognize issues related to compliance reports, such as questioned costs, fraud, and equity skimming.
- Determine how audit sampling may be used in tests of internal control over compliance and tests of compliance with laws and regulations.
- Identify special considerations that may apply when performing a compliance audit for a nonprofit HUD-assisted entity.

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Lesson 1: Authoritative Literature; the Current Compliance Environment; and Responsibility for Laws, Regulations, and Other Matters

INTRODUCTION

The HUD audit consists of two components: the financial statement audit and the compliance audit. The compliance portion of the audit assists HUD in determining whether the HUD-assisted entity has complied with all of the requirements of the HUD program and has correctly utilized program funds. The compliance audit procedures are designed to test compliance with HUD program requirements and allow the auditor to express an opinion on the entity's compliance with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each of its major HUD programs.

AU-C 935, *Compliance Audits*, provides guidance for audits of an entity's compliance with compliance requirements of a governmental audit requirement. AU-C 935 is applicable for all HUD audits because it applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with GAAS, *Government Auditing Standards* (the Yellow Book), and a governmental audit requirement that requires an opinion on compliance, such as the *Consolidated Audit Guide for Audits of HUD Programs* (the HUD audit guide) for for-profit audits or OMB's Uniform Guidance (2 CFR part 200, subpart F) for nonprofit audits.

This course discusses how to plan and perform tests of compliance with laws and regulations governing multifamily project owners that receive assistance under a HUD program. The consideration of internal control in a compliance audit is also discussed. The HUD compliance guidance for for-profit audits is based primarily on Chapter 3 of the HUD audit guide (Handbook 2000.04, REV-2 CHG-7), which was issued by the HUD OIG in July 2008. However, this course also includes relevant new requirements or guidance issued by HUD after the latest version of Chapter 3 was released.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify important aspects of authoritative literature that applies to HUD compliance audits and the current compliance environment.
- Determine the auditor's responsibility for laws, regulations and other matters in a HUD compliance audit.

How 2013 Revisions of the HUD Audit Guide Affect the Compliance Audit

Use of the HUD Audit Guide for Audits of Nonprofit HUD-assisted Entities. Chapter 1 of the HUD audit guide, "General Audit Guidance," addresses the applicability of the HUD audit guide for audits of nonprofit HUD-assisted entities. Paragraph 1-2 of the HUD audit guide clearly states that in the case of nonprofit entities that participate in HUD programs, ". . . auditors should normally use OMB's Compliance Supplement to perform the audit *and not this audit guide*." [Emphasis added.]

Applicability of This Course for Audits of Nonprofit HUD-assisted Entities. While this course focuses primarily on audits of for-profit multifamily HUD-assisted entities, most sections address the authoritative guidance for compliance auditing in general. Accordingly, much of the discussion would be applicable to both for-profit and nonprofit HUD audits. Considerations that are specific only to audits of for-profit HUD entities under the HUD audit guide, or to nonprofit HUD entities under OMB's Uniform Guidance, are described accordingly. Also, specific guidance about the requirements in OMB's Uniform Guidance and the Compliance Supplement that need to be considered in Single Audits of nonprofit HUD-assisted entities is discussed in Lesson 3.

Elimination of Audit Requirement for Small For-profit Multifamily Housing Projects. HUD Housing Notice H 2013-23 exempts small for-profit multifamily housing projects (i.e., those that receive less than $500,000 in combined federal financial assistance) from the requirement to obtain an audit. Instead, the owners of such projects may submit an owner-certified financial statement.

Authoritative Literature

The following authoritative literature is relevant to compliance audits of HUD-assisted entities:

- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud and determining the overall and specific responses to those risks.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for obtaining an understanding of the legal and regulatory framework relevant to the industry or sector in which the entity operates and how the entity complies with that framework.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Evidence Obtained*, establishes requirements for determining the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.
- AU-C 530, *Audit Sampling*, addresses the auditor's use of statistical and nonstatistical sampling.
- AU-C 935, *Compliance Audits*, establishes requirements and provides guidance for performing and reporting on an audit of an entity's compliance with applicable compliance requirements of a governmental audit requirement.
- GAO *Government Auditing Standards, 2018 Revision Technical Update April 2021* (the Yellow Book), incorporates GAAS and adds additional reporting requirements concerning compliance with laws and regulations and internal control.
- (For-profit audits) *Consolidated Audit Guide for Audits of HUD Programs* (the "HUD audit guide") provides the specific compliance requirements for HUD programs. It requires auditors to report on compliance and internal control over compliance.
- (Nonprofit audits) Title 2 U.S. *Code of Federal Regulations* (CFR) Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance).
- (Nonprofit audits) *Federal Awarding Agency Regulatory Implementation of Office of Management and Budget's Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards*.
- (Nonprofit audits) HUD Notice SD-2015-01, *Transition to 2 CFR Part 200, Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards, Final Guidance*.
- AICPA Audit Guide, *Government Auditing Standards and Single Audits*.
- AICPA Audit Guide, *Audit Sampling* (the AICPA Sampling Guide).

Applicability of the AICPA Audit Guide. The AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), presents guidance for financial statement audits performed under *Government Auditing Standards* in Part I. This guidance applies to all HUD audits, both for-profit and nonprofit audits. It provides guidance for compliance audits conducted under the Single Audit Act and the Uniform Guidance in Part II. Although the guidance in Part II only specifically applies to audits of HUD nonprofit entities performed in accordance with the Uniform Guidance, the authors believe that much of the general guidance in Part II for performing compliance audits ought to be considered in all HUD audits and have incorporated it in this course where relevant. This course reflects guidance available in the April 2022 edition of the GAS/SA Audit Guide.

AU-C 935, *Compliance Audits*

AU-C 935 is the primary source of guidance in GAAS for a compliance audit. It applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following—

- Generally accepted auditing standards;
- *Government Auditing Standards* requirements for financial audits; and
- A governmental audit requirement that requires an opinion on compliance, such as the HUD audit guide or OMB's Uniform Guidance.

AU-C 935 does not apply to the financial statement audit component of a HUD audit. It requires auditors to use professional judgment to adapt and apply relevant GAAS to the audit of compliance and provides guidance on how to do so. However, this does not mean the auditor has to literally translate every procedure applicable in a financial statement audit. Instead, the auditor modifies and applies the GAAS procedures considered relevant and necessary for obtaining sufficient appropriate audit evidence to support an opinion on compliance.

The GAS/SA Audit Guide, Paragraph 6.06, notes that AU-C 935.06 indicates some sections of GAAS can be adapted and applied to a compliance audit with relative ease. This might be done, for example, by simply replacing the word *misstatement* with the word *noncompliance*. However, other sections are more difficult to adapt and apply without further modification. Accordingly, AU-C 935 provides specific guidance on how to adapt and apply certain AU-C sections to a compliance audit. The GAS/SA Audit Guide goes even further and provides specific guidance on adapting them in audits conducted in accordance with the Yellow Book and the OMB's Uniform Guidance.

Some sections of GAAS generally cannot be adapted and applied to a compliance audit. The Appendix at AU-C 935.A43 lists several sections that are not applicable, either because (a) they are *not* relevant to a compliance audit, (b) they would not contribute to meeting the audit objectives, or (c) the subject matter is specifically covered by AU-C 935. (However, the auditor is not precluded from applying the listed standards if he or she believes they will provide appropriate audit evidence to support the opinion on compliance in the circumstances.)

Definitions of Key Terms. AU-C 935.11 provides definitions for several terms that are specific to compliance audits, including the following:

- *Audit Risk of Noncompliance.* The risk that the auditor expresses an inappropriate audit opinion on compliance when material noncompliance exists. Audit risk of noncompliance is a function of the risks of material noncompliance and detection risk of noncompliance.
- *Compliance Audit.* A program-specific audit or an organization-wide audit of an entity's compliance with applicable compliance requirements.
- *Compliance Requirements.* Laws, statutes, regulations, rules, and provisions of contracts or grant agreements applicable to a government program that require compliance by an entity. *Applicable compliance requirements* are those that are subject to the compliance audit.
- *Deficiency in Internal Control over Compliance.* A deficiency in internal control over compliance exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis.
    - *Deficiency in Design.* A control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.
    - *Deficiency in Operation.* A properly designed control does not operate as designed or the person performing the control does not have the necessary authority or competence to perform it effectively.

- *Detection Risk of Noncompliance.* The risk that the procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated, with other instances of noncompliance.
- *Governmental Audit Requirement.* A government requirement established by law, statute, regulation, rule, or provision of contracts or grant agreements that an entity obtain an audit of its compliance with applicable compliance requirements of government programs.
- *Government Program.* The means by which a government achieves its objectives. For example, the National School Lunch Program is intended to achieve the USDA objective of providing nutrition to individuals in need. Government programs that are relevant for compliance audit purposes are those where a grantor or pass-through entity provides an award to another entity, usually in the form of a grant, contract, or other agreement.
- *Material Noncompliance.* Noncompliance with the applicable compliance requirements is considered quantitatively or qualitatively material if there is a substantial likelihood that, individually or in the aggregate, it would influence the judgment made by a reasonable user of the report on compliance about the entity's compliance with the requirements of the government program as a whole.
- *Material Weakness in Internal Control over Compliance.* A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable.
- *Organization-wide Audit.* An audit of an entity's financial statements and an audit of its compliance with the applicable compliance requirements as they relate to one or more government programs that the entity administers.
- *Program-specific Audit.* An audit of an entity's compliance with applicable compliance requirements as they relate to one government program that the entity administers. The compliance audit portion of a program-specific audit is performed in conjunction with an audit of either the entity's financial statements or the program's financial statements. (The definition for program-specific audit used in AU-C 935 differs from that used in the Uniform Guidance.)
- *Questioned Costs.* Costs that are questioned by the auditor because they (a) violate (or possibly violate) the applicable compliance requirements, (b) are not supported by adequate documentation, or (c) appear unreasonable and do not reflect the actions of a prudent person under the circumstances.
- *Risk of Material Noncompliance.* The risk that material noncompliance exists prior to the audit. This consists of the inherent risk of noncompliance and the control risk of noncompliance.
- *Significant Deficiency in Internal Control over Compliance.* A deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

As noted in the previous paragraph, AU-C 935 defines *applicable compliance requirements* as the compliance requirements that are subject to the compliance audit. In HUD audits, the auditor is required to express an opinion on compliance with requirements that could have a direct and material effect on a major HUD program. Therefore, in a compliance audit performed accordance with either the HUD audit guide (for-profit entities) or OMB's Uniform Guidance (nonprofit entities), the applicable compliance requirements, as the term is used in AU-C 935, are those that could have a direct and material effect on a major HUD program. For the purpose of adapting AU-C 935 to a HUD audit, the term *applicable* is often replaced by *direct and material* in this course in the discussions of compliance auditing procedures.

Compliance Audit Objectives. AU-C 935.10 explains that the auditor has the following objectives in a compliance audit:

- To obtain sufficient appropriate audit evidence to form an opinion and report at the level specified in the governmental audit requirement about whether the entity complied in all material respects with the applicable compliance requirements.
- To identify audit and reporting requirements specified in the governmental audit requirement that are supplementary to GAAS and *Government Auditing Standards*, if any, and perform procedures to address those requirements.

Performance Requirements. While AU-C 935 provides guidance on adapting and applying GAAS in a compliance audit, its requirements extend beyond GAAS for financial audits. Significant requirements for performing a compliance audit are discussed in the following paragraphs.

Establish Materiality. AU-C 935.13 states that the auditor should determine and apply materiality levels based on the governmental audit requirement. In a compliance audit, materiality levels are used for:

a. Determining the nature and extent of risk assessment procedures.

b. Identifying and assessing the risks of material noncompliance.

c. Determining the nature, timing, and extent of further audit procedures.

d. Evaluating whether the entity complied with the direct and material compliance requirements.

e. Reporting findings of noncompliance and other matters required to be reported by the governmental audit requirement.

AU-C 935.13 states that materiality for a compliance audit should be determined in relation to the governmental audit requirement. In an audit of a HUD entity, the auditor is required to report noncompliance that is material to a compliance requirement.

Identify Programs and Compliance Requirements to Test. AU-C 935.14 states that the auditor should determine which programs and compliance requirements to test (i.e., the applicable compliance requirements). AU-C 935 cites the *OMB Compliance Supplement* as a framework for determining applicable compliance requirements. For HUD audits, the *OMB Compliance Supplement* is used in Single Audits of nonprofit HUD-assisted entities. In a HUD audit of a for-profit entity, the HUD audit guide provides the framework for determining applicable compliance requirements. The compliance requirements for HUD-assisted for-profit multifamily entities are those specified by Chapter 3 of the HUD audit guide.

AU-C 935.A11 provides the following additional examples of procedures the auditor might consider for determining applicable compliance requirements:

- Read laws, statutes, regulations, rules, and provisions of contracts or grant agreements that relate to the program being audited.
- Make inquiries of management and other knowledgeable individuals (both inside and outside the entity).
- Read minutes of governing board meetings.
- Read documentation of applicable compliance requirements from previous audits or other engagements and, if applicable, discuss them with auditors who performed the prior audits or other engagements.

Perform Risk Assessment Procedures. AU-C 935.15 states that the auditor should perform risk assessment procedures to obtain an understanding of compliance requirements and related internal control over such compliance requirements for each program and compliance requirement selected for testing. The procedures should include:

- Inquiring of management about whether reports or other written communications from previous audits, attestation engagements, and internal or external monitoring have findings and recommendations that directly relate to the objectives of the compliance audit.
- Obtaining an understanding of management's response (for example, corrective actions) to findings and recommendations that could have a material effect on compliance with the applicable compliance requirements.
- Using the information obtained about the findings and recommendations to assess risk and determine the nature, timing, and extent of compliance audit procedures, including procedures to test corrective actions.

Paragraph 6.30 of the GAS/SA Audit Guide explains that obtaining an understanding of the federal program, compliance requirements subject to audit that are direct and material, and internal control over compliance establishes a frame of reference within which the auditor plans the compliance audit and exercises professional judgment regarding identifying and assessing risks of material noncompliance and responding to those risks during the audit.

The nature and extent of risk assessment procedures may vary among entities and are influenced by factors such as the following:

- The newness and complexity of the direct and material compliance requirements.
- The nature of the compliance requirement.
- The auditor's knowledge of the entity's internal control over compliance with the direct and material compliance requirements obtained in previous audits or other engagements.
- The services provided by the entity and how external factors affect the services.
- The amount of oversight by the grantor.
- The ways management addresses findings.

Assess Risks of Material Noncompliance. AU-C 935.17 states that for each applicable compliance requirement, the auditor should identify and assess the risks of material noncompliance, whether due to error or fraud, and consider whether any of these risks might affect multiple compliance requirements (that is, whether the risks are pervasive). For example, there might be a pervasive risk of noncompliance if the entity has financial difficulties that present an increased risk of HUD funds being used for unauthorized purposes, or if the entity has poor record-keeping for its HUD-assisted programs. The auditor should develop an overall response to any pervasive risks of material noncompliance that are identified.

In identifying and assessing the risks of material noncompliance, the auditor might consider several factors, including the following:

- The complexity of the direct and material compliance requirements, their susceptibility to noncompliance, and the length of time the entity has been subject to them.
- The auditor's knowledge about the entity's compliance with the direct and material compliance requirements in prior years.
- The potential effect on the entity of noncompliance with the direct and material compliance requirements.
- The amount of judgment needed to satisfy the direct and material compliance requirements.
- The auditor's assessed risks of material misstatement in the financial statement audit.

Perform Further Audit Procedures. The auditor should design and perform further audit procedures in response to the assessed risks of material noncompliance. AU-C 935.19 states that risk assessment procedures, tests of controls, and analytical procedures alone are not sufficient to address a risk of material noncompliance. The auditor should design and perform further audit procedures, including tests of details or transactions, to obtain sufficient appropriate audit evidence about compliance with each of the applicable compliance requirements.

Further audit procedures should include *tests of details* and may include *tests of transactions*. For example, tests of details (and tests of transactions) might be performed in the following areas.

- Program receipts and expenditures.
- Eligibility files.
- Periodic reports filed with HUD and other grantor agencies.

AU-C 935.20 states that the auditor also should perform *tests of controls* over each applicable compliance requirement if any of the following conditions apply:

- Tests of controls over compliance are required by the governmental audit requirement—for example, as required by the HUD audit guide and OMB's Uniform Guidance.
- The risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirement.
- Substantive procedures alone do not provide sufficient appropriate audit evidence.

There is an important difference in GAAS between tests of controls in a financial statement audit and tests of controls in a compliance audit. In a financial statement audit, the auditor can use audit evidence about the operating effectiveness of controls obtained in prior audits. However, Paragraph 9.46 of the GAS/SA Audit Guide points out that AU-C 935 specifically excludes the applicability of AU-C 330.13–.14 and AU-C 330.31, which address the use of evidence about the effectiveness of controls obtained in prior audits. Therefore, in a compliance audit, the auditor is not permitted to use evidence about the operating effectiveness of controls obtained in prior audits.

Paragraph 9.43 of the GAS/SA Audit Guide explains, however, that consideration of the results of prior years' tests can provide important information for planning tests of controls in the current compliance audit. If the results of the prior tests of controls prevented the auditor from assessing a low level of control risk of noncompliance, the auditor might consider expanding the testing in the current audit. Testing changes in internal control over compliance that were intended to eliminate deficiencies noted in the previous year might also provide relevant information. If, however, the auditor concluded in the prior year that internal control over compliance for one or more compliance requirements was ineffective, and no changes were made to the internal control over compliance, the auditor might determine that controls are not likely to be effective and choose not to plan and perform tests of controls. As discussed in Lesson 2, the auditor would then consider the effect on his or her reports on internal control. (Lesson 3 discusses the auditor's consideration of results of prior years' tests if controls have changed as a result of implementing the Uniform Guidance.)

Determine Supplementary Governmental Audit Requirements. AU-C 935.21 states that the auditor should determine applicable governmental audit requirements that are supplementary to GAAS and *Government Auditing Standards*, and perform procedures to address those requirements. For example, supplementary audit requirements include the HUD audit guide and Uniform Guidance requirements that the auditor (a) perform specific procedures to identify major programs and (b) follow up on prior audit findings.

Outdated or Conflicting Guidance. If audit guidance provided by a governmental agency has not been updated for, or otherwise conflicts with, current GAAS or *Government Auditing Standards*, AU-C 935.22 requires the auditor to comply with the most current applicable GAAS and *Government Auditing Standards*, rather than the outdated or conflicting guidance. In that situation, the auditor may want to consult with the governmental entity that established the audit guidance or provided the funding.

As discussed in Paragraph 10.26 of the GAS/SA Audit Guide, compliance requirements change periodically and there will be delays before these changes can be reflected as revisions to the HUD audit guide or the *OMB Compliance Supplement*. Paragraph 1-1 of the HUD audit guide states, "the auditor should perform reasonable procedures to ensure that compliance requirements are current and to determine whether there are any additional provisions of contracts and grant agreements that should be covered" by the HUD audit. The paragraph goes on to explain that reasonable procedures are considered to include inquiry of the entity's management and review of contracts and grant agreements that pertain to major programs.

<u>Request Management Representations.</u> The auditor should request written representations from management. AU-C 935.23 indicates the representations should be tailored to the entity and the governmental audit requirement.

<u>Perform Subsequent Events Procedures.</u> Subsequent events procedures should be performed up to the date of the auditor's report to obtain sufficient appropriate audit evidence that all subsequent events related to compliance during the period covered by the auditor's report on compliance have been identified. AU-C 935.26 states that the nature and extent of such procedures should take into account the auditor's risk assessment and should include, but not be limited to, inquiring of management about and considering the following:

- Relevant reports issued by internal auditors during the subsequent period.
- Reports issued by other auditors during the subsequent period identifying noncompliance.
- Reports on noncompliance issued by grantor and pass-through entities during the subsequent period.
- Information about noncompliance obtained through other engagements performed for the entity.

The auditor is not required to perform procedures related to noncompliance occurring after the period covered by the auditor's report. However, the auditor should discuss with management and, if appropriate, those charged with governance any such noncompliance that the auditor becomes aware of before the report release date if disclosure of the noncompliance is necessary to keep the auditor's report from being misleading. An example of such a matter might be noncompliance occurring in the subsequent period that is so significant that HUD stopped funding the program or the project owner was subject to administrative actions or sanctions. According to AU-C 935.27, the auditor's report should include an other-matter paragraph describing the nature of such noncompliance.

<u>Evaluate the Sufficiency and Appropriateness of Audit Evidence.</u> AU-C 935.28 states that the auditor should evaluate the sufficiency and appropriateness of audit evidence obtained. The GAS/SA Audit Guide, Paragraph 10.58, explains this may include consideration of the following factors:

- The frequency and nature of noncompliance with the direct and material compliance requirements identified.
- The adequacy of the entity's system for monitoring compliance with the direct and material compliance requirements and the possible effect on the entity of any noncompliance.
- Whether identified noncompliance with the direct and material compliance requirements resulted in likely questioned costs that are material to the program.

The evaluation of noncompliance identified by the auditor includes noncompliance that was corrected after being brought to management's attention.

Reporting Requirements. AU-C 935.29 states that when the auditor is engaged to opine on whether the entity complied in all material respects with the applicable compliance requirements, the opinion should be at the level specified by the governmental audit requirement. For compliance audits of HUD entities, both the HUD audit guide (for-profit audits) and the Uniform Guidance (nonprofit audits) require the auditor to issue an opinion (or to disclaim an opinion) on whether the entity complied, in all material respects, with laws, regulations, and the provisions of contracts and grant agreements that could have a direct and material effect on each major program.

AU-C 935.29 states that, in forming an opinion, the auditor should evaluate (a) known and likely questioned costs and (b) other material noncompliance that, typically, might not have questioned costs. For example, noncompliance with a reporting requirement typically does not result in questioned costs.

AU-C 935 allows the auditor to issue a combined report on compliance and internal control over compliance or to issue two separate reports—a report on compliance and a report on internal control over compliance. The example reports in Chapter 2 of the HUD audit guide and the appendixes to Chapter 13 of the GAS/SA Audit Guide illustrate a combined report on compliance and internal control over compliance. Alternatively, the auditor might issue two separate reports.

Communication with Those Charged with Governance. AU-C 935.38 states that the auditor should communicate the following to those charged with governance:

- The auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement (that is, the HUD audit guide or the Uniform Guidance).
- An overview of the planned scope and timing of the compliance audit.
- Any significant deficiencies and material weaknesses in internal control over compliance that the auditor identified during the compliance audit.

Although outside the scope of this course, more information on the auditor's responsibilities for communicating with those charged with governance and management can be found in *PPC's Guide to HUD Audits*.

Documentation. In a compliance audit, the auditor should document the following:

- The risk assessment procedures performed, including procedures to obtain an understanding of internal control over compliance (AU-C 935.40).
- The auditor's responses to the assessed risks of material noncompliance, procedures performed to test compliance with the applicable compliance requirements (i.e., the compliance requirements subject to audit that are direct and material), and the results of those procedures, including any tests of controls over compliance (AU-C 935.41).
- Materiality levels and the basis on which they were determined (AU-C 935.42).
- How the auditor complied with specific governmental audit requirements that are supplementary to the requirements of GAAS and *Government Auditing Standards* (AU-C 935.43).

Considerations for audit documentation requirements are discussed where applicable in this course.

An Emphasis Point at Paragraph 10.76 of the GAS/SA Audit Guide points out that some quality control reviews performed by federal agencies had findings in which audit documentation did not provide sufficient evidence that work was performed to support the auditor's opinion(s) on compliance. In certain cases, the audit documentation did not (a) contain evidence that the auditor tested certain compliance requirements identified as subject to audit in the Part 2 Matrix of Compliance Requirements for a major program or (b) explain why certain compliance requirements identified in the Compliance Supplement as subject to audit in the Part 2 Matrix of Compliance Requirements were not determined by the auditor to be direct and material to a major program. Among other things, the auditor should document the individual tests performed and the results of those tests.

Types of Entities Subject to the Compliance Requirements in Chapter 3 of *Consolidated Audit Guide for Audits of HUD Programs*

For-profit entities that receive financial assistance under a HUD multifamily housing program generally must be tested for compliance with the requirements set forth in Chapter 3, "HUD Multifamily Housing Programs," of the HUD audit guide. (However, see below for discussion of an exemption for small multifamily housing projects.) The guidance and requirements provided by HUD in Chapter 3 are discussed in more detail in Lesson 2.

However, an entity is not required to obtain an audit in accordance with the HUD audit guide if the *only* assistance it receives from HUD is received under one of the following programs:

- Section 8 Existing Housing Program (24 CFR 882, subpart A).
- Section 8 Moderate Rehabilitation Projects (24 CFR 882, subparts D and E).

- Shelter Plus Care Rental Assistance (assistance to homeless persons) (24 CFR 583).
- Housing Opportunities for Persons With AIDS (24 CFR 574).
- Housing assistance under the HOME Investment Partnership Act.
- Housing assistance under the "Housing Opportunities for People Everywhere" (HOPE) multifamily housing program.
- Section 8 for Single Room Occupancy (24 CFR 882, subpart H).

Such entities would, however, still be subject to the compliance requirements in *Government Auditing Standards*. While projects under the Section 8 for Single Room Occupancy Program (listed above) generally do not have to follow the HUD audit guide, the following projects must follow the HUD audit guide:

- Projects assisted under the Section 8 new construction or substantial rehabilitation programs.
- Loan management and property disposition set-aside projects.
- Projects with HUD-insured or coinsured mortgages.

HUD may contract with state housing finance agencies to administer a Section 8 rent subsidy program on HUD's behalf. As contract administrators, state housing finance agencies perform their own compliance reviews of the assisted entities and may request that the entities engage the auditor to conduct only a financial audit. Auditors need to inquire of the state housing finance agency about whether it desires both a financial and compliance audit, or just a financial audit. Some state housing finance agencies have developed their own audit guides for HUD-assisted entities.

Audit Scope and Determination of Major Programs

For-profit Entities. According to Paragraph 1-3(B) of the HUD audit guide, when a for-profit entity expends assistance equal to or in excess of $500,000 in a year under a HUD program, that program is considered a major HUD program. For example, if a project expends $500,000 or more in Section 8 assistance in a year, the Section 8 program is a major program. Also, according to the HUD audit guide, if the outstanding balance of a HUD-insured or HUD-guaranteed loan equals or exceeds $500,000 as of the date of the financial statements, the program is a major program. The auditor is required to express an opinion on the auditee's compliance with requirements applicable to major HUD programs.

Nonprofit Entities. In an audit of a HUD-assisted nonprofit entity, the auditor is also required to express an opinion on compliance with the requirements applicable to a HUD program if it is determined to be a *major* federal program for that entity. As discussed in Lesson 3, major programs for nonprofit entities are determined by a risk-based approach specified by OMB's Uniform Guidance.

Exemption from Reporting Requirement for Small For-profit Multifamily Housing Projects. HUD Housing Notice H 2013-23 revises the financial reporting requirements for small for-profit multifamily housing projects effective for years ending December 31, 2013, and later. For purposes of HUD Notice H 2013-23, a small multifamily housing project is one for which the owner has an obligation to submit an audited financial statement to HUD but receives less than $500,000 in combined federal financial assistance. HUD Housing Notice H 2013-23 permits owners of such projects to submit an owner-certified financial statement instead of audited financial statements. Owners still have to submit GAAP-basis financial statements, including notes thereto, via REAC. However, the owner-certified submissions will not contain an auditor's opinion or an auditor's report on compliance and internal controls. During the submission process, the FASSUB system will prompt owners to certify that they receive less than $500,000 in combined federal financial assistance, and the system will perform a crosscheck of HUD's databases to verify the certification.

TRENDS IN THE CURRENT COMPLIANCE ENVIRONMENT

The following paragraphs highlight current trends in the compliance environment relevant to audits of HUD-assisted entities.

Concerns with Substandard Audits

HUD Office of Inspector General. The HUD Office of Inspector General (HUD OIG) is responsible for promoting the integrity, efficiency, and effectiveness of HUD programs. One of the office's responsibilities is to issue and update the HUD audit guide. Accordingly, the HUD OIG is concerned with audit quality and uses the results of its audit documentation reviews to monitor how auditors are using the HUD audit guide and meeting the professional and regulatory requirements.

In past years, representatives from the HUD OIG have stated that OIG audits of HUD-assisted projects found several common problems with compliance with HUD program requirements. Some of these problems include:

- Unallowed costs charged to projects,
- Many projects operated by the same management entity but all indirect costs charged to one project; cost distributions were arbitrary and not supportable,
- Owner made cash withdrawals when project was not in "surplus cash" position,
- Surplus cash withdrawn at other than allowed semiannual or annual fiscal periods,
- Funds withdrawn by owner and replaced at end of reporting period,
- Disbursements made from the reserve for replacement account without HUD approval,
- Unsupported disbursements,
- Project funds improperly loaned to related entities,
- Missing tenant eligibility documentation and missing tenant file documentation,
- Unsupported housing assistance payments,
- Appropriate accounting procedures and controls at the project had not been established,
- Financial activities of the owner commingled in the project accounting records,
- Laundry and other income diverted to the owner,
- Management fees in excess of HUD-approved amounts, and
- Equity skimming.

The discussions in this course are designed to assist the auditor with detecting potential areas of noncompliance, such as those identified by the HUD OIG.

Procedures and requirements in Chapter 3 of the HUD audit guide are designed to address audit weaknesses revealed during OIG reviews of audit documentation. These weaknesses have included:

- Deficiencies in acceptable auditing criteria, poor audit documentation, and insufficient sample sizes;
- Insufficient tests of compliance, pointing to a need for increased focus on auditing cash receipts, cash disbursements, and tenant security deposits;
- Evidence of equity skimming and other compliance failures going undetected; and
- Incomplete audit programs and audit programs not appropriately customized.

AICPA Peer Review Findings. In its ongoing efforts to improve audit quality the AICPA Peer Review division periodically makes available some of the data collected during peer reviews. In a report addressing matters noted in recent peer reviews, the AICPA noted several findings pertaining to the governmental, Single Audit, and HUD audit practice areas. With respect to documentation and performance of the compliance audit, the following matters relate to Single Audits; however, the authors believe all HUD auditors need to be aware of (and avoid) peer review issues in which the auditor did not document—

- an understanding of internal control over compliance for federal awards that was sufficient to plan the audit to support a low assessed level of control risk for major programs, including findings that the auditor did not consider the risk of material noncompliance related to each compliance requirement and major program.
- testing of internal controls and compliance for the relevant assertions for each compliance requirement with a direct and material effect for each major program, including insufficient documentation and usage of dual-purpose testing.
- the adequacy of the planned sample size for test of controls over compliance (for Single Audits, the auditor needs to plan to achieve a low level of control risk).
- the evaluation of management's skills, knowledge, and experience to effectively oversee nonaudit services performed by the auditor.
- applicable management representations tailored to the entity and the compliance audit relating to federal awards.
- internal controls over the preparation of the schedule of expenditures of federal awards.

With respect to Single Audits, there also were failures to identify and test sufficient and appropriate major programs, sometimes because the auditor used preliminary program expenditures during planning and did not update the planning with final expenditure amounts; failures to properly cluster or group programs; and incorrect determination of low-risk auditee status.

In June 2018, the AICPA Peer Review Board issued a special addition of their *Review Alert* focusing on Single Audits from enhanced oversight reviews of 2016 peer reviews. In addition to the items mentioned in the previous paragraph, audit deficiencies were noted for failure to document the following:

- Requirements in the Yellow Book, Paragraph 3.59, relating to auditor independence and nonaudit services.
- Rationale for concluding that a compliance requirement was not direct and material and therefore did not require testing.
- Assessment of risk of material noncompliance due to fraud for each major program.
- Procedures performed over the fair presentation of the schedule of expenditures of federal awards in relation to the financial statements as a whole.

Previous editions of the AICPA Audit Risk Alert, *Government Auditing Standards and Single Audit Developments*, highlighted the following common deficiencies that apply to auditing compliance in HUD audits found during peer reviews and AICPA Professional Ethics division investigations:

- Incorrect use of the HUD audit guide to satisfy OMB audit requirements.
- Insufficient audit work performed to support the opinion of many projects managed by the project owner/management agent. This finding is based in part on the fact that some auditors did not audit compliance requirements of each project, but instead tested requirements of some projects, applying the results from those projects as if they applied as well to the untested projects. Auditors are warned that HUD limits this type of testing in Chapter 3 of the HUD audit guide. Group project-based sampling is discussed in more detail in Lesson 2.

Creative Compensation Arrangements Involving Identity-of-interest Entities

Some affiliates of HUD-assisted entities have established *creative* compensation arrangements involving identity-of-interest companies. One typical arrangement involves a general partner in a HUD-assisted project who also serves as the management agent and attempts to extract profits from related party service contracts through artificially inflated fees for services rendered to the project.

Wider Participation in HUD Programs

The Sections 202 and 811 "new construction" programs have attracted an eclectic group of sponsoring organizations ranging from local religious organizations to community organizations for the developmentally disabled. Auditors need to be aware that such organizations often lack an awareness of compliance issues; for example, a church-affiliated sponsor of a Section 202 project for the elderly may unknowingly give preferential consideration to the elderly members of its congregation when processing applications.

HUD is developing programs to preserve and rehabilitate housing for low-income, elderly, and disabled persons. As a result, ownership of some multifamily projects will transfer to new for-profit or nonprofit owners that may not be familiar with HUD's regulatory requirements.

Trend Toward Greater CPA Involvement in the Detection of Noncompliance

HUD continues to downsize, and with fewer personnel available to conduct inspections of project owners, HUD looks to auditors to be its "partner" in detecting noncompliance with HUD laws and regulations. One example of this is the CPA attestation requirement relating to the electronic submission of the project owner's financial information. It is expected that this trend toward greater CPA involvement will continue, with special emphasis in the areas of tenant eligibility and nondiscrimination in applicant screening, maintenance of property, and misuse of funds.

Program Fraud Alerts

"Program Fraud Alerts" are notices issued by the HUD OIG to address national trends in housing fraud. A Program Fraud Alert was issued to discuss violations of applicable statutes and HUD requirements involving equity skimming. Equity skimming is broadly defined in the alert as "the misuse or diversion of project assets or income by project owners or management agents." Equity skimming results in the realization of losses to the FHA insurance funds and deprives projects of needed funds for repairs and maintenance. Equity skimming as a compliance area in the HUD audit guide is discussed further in Lesson 2.

The regulatory agreement between the project owner and HUD specifies that expenditures must be "reasonable and necessary to the project" and limits the cash or other assets the owner may take out of the project. Therefore, the use of project assets or income for other than reasonable operating expenses and necessary repairs or for the payment of unauthorized distributions to the owner constitutes a violation of the regulatory agreement.

The civil penalty for the use of project funds in violation of the regulatory agreement can be double the value of any assets or income of a project that was used in violation of the regulatory agreement plus reasonable attorney and audit fees. HUD can seek to recover those damages against project owners who use project assets or income and do not maintain adequate supporting documentation for the expenditure. HUD does not have to prove criminal intent.

The misuse of project funds can also be prosecuted as a criminal matter if the equity skimming occurs "in a period during which the mortgage note is in default or the project is in a nonsurplus cash position, as defined by the regulatory agreement." Violation of this provision is a felony and can be punished by up to five years imprisonment and fines up to $500,000.

If the project is in a nonsurplus cash position or is in default, the following actions could constitute equity skimming:

- Cash distributions or withdrawals.
- Repayment of advances made to the project by the owner or management agent.
- Lending funds to owners, partners, affiliates, or the management agent.

- Payments of principal and/or interest on any secondary financing without HUD approval.
- Sharing of management fees with the project owner.
- Purchasing equipment or services not for use by the project with project funds.
- Paying more for services and supplies than could be procured on the open market.
- Payment of construction or rehabilitation costs from operations instead of mortgage proceeds.
- Payments to consultants, attorneys, or accountants for partnership activities that are not reasonable and necessary operating expenses of the project.
- Personal or other business loan payments.

Awareness of these actions and conditions is important when performing the audit.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. Which of the following statements best describes AU-C 935, *Compliance Audits*?
   a. It is the main source of guidance for auditors performing a HUD compliance audit.
   b. It applies to the financial statement audit component of a HUD audit engagement.
   c. It provides guidance on how auditors can use judgment to adapt GAAS to compliance audits.
   d. It requires that all sections of GAAS be adapted to a compliance audit.
2. Why might certain costs be considered *questioned costs*?
   a. They are supported by reliable documentation.
   b. They violate applicable compliance requirements.
   c. They reflect the actions of management.
   d. They lead to material noncompliance.
3. Under what circumstances might a HUD auditor need to perform tests of controls over applicable compliance requirements?
   a. Substantive procedures will provide sufficient appropriate audit evidence.
   b. The governmental agency provides outdated or conflicting guidance.
   c. Subsequent events occur that may affect the entity's financial statements.
   d. They are required by the governmental audit requirement.
4. All of the following are common problems the HUD Office of Inspector General (HUD OIG) has found in audits of HUD-assisted projects **except**:
   a. Indirect costs charged to one project instead of multiple projects.
   b. Owners making withdrawals of the project's surplus cash.
   c. The lack of appropriate accounting procedures at the project.
   d. Fees paid to management in unapproved amounts.
5. Why does the HUD OIG issue Program Fraud Alerts?
   a. To prohibit creative compensation arrangements with identity-of-interest companies.
   b. To address compliance issues with "new construction" programs.
   c. To address national trends involving housing fraud.
   d. To address the effects of fewer personnel as the HUD downsizes.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. Which of the following statements best describes AU-C 935, *Compliance Audits*? **(Page 133)**

   a. It is the main source of guidance for auditors performing a HUD compliance audit. [This answer is incorrect. AU-C 935 is the primary source of guidance *in generally accepted auditing standards (GAAS)* for a compliance audit. However, other authoritative literature exists that applies to compliance audits of HUD-assisted entities, including the AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide); *Government Auditing Standards* (the Yellow Book); and the OMB's Uniform Guidance.]

   b. It applies to the financial statement audit component of a HUD audit engagement. [This answer is incorrect. AU-C 935 does *not* apply to the financial statement audit component of a HUD audit. It applies when the auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with (1) GAAS; (2) Yellow Book requirements for financial audits; and (3) a governmental audit requirement that requires an opinion on compliance, such as the HUD audit guide or OMB's Uniform Guidance.]

   c. **It provides guidance on how auditors can use judgment to adapt GAAS to compliance audits. [This answer is correct. AU-C 935 requires auditors to use professional judgment to adapt and apply relevant GAAS to the audit of compliance and provides guidance on how to do so. The auditor modifies and applies the GAAS procedures considered relevant and necessary for obtaining sufficient appropriate audit evidence to support an opinion on compliance.]**

   d. It requires that all sections of GAAS be adapted to a compliance audit. [This answer is incorrect. Some sections of GAAS generally *cannot* be adapted and applied to a compliance audit, so this is not a requirement found in AU-C 935. The Appendix at AU-C 935.A43 lists several sections that are not applicable, either because (1) they are *not* relevant to a compliance audit, (2) they would not contribute to meeting the audit objectives, or (c) the subject matter is specifically covered by AU-C 935.]

2. Why might certain costs be considered *questioned costs*? **(Page 133)**

   a. They are supported by reliable documentation. [This answer is incorrect. According to the definition of *questioned costs* in AU-C 935.11, one reason they would be questioned by the auditor is that they are *not* supported by adequate documentation.]

   b. **They violate applicable compliance requirements. [This answer is correct. According to the definition in AU-C 935.11, *questioned costs* are questioned by the auditor for three reasons. One of those reasons is that they violate (or possibly violate) the applicable compliance requirements.]**

   c. They reflect the actions of management. [This answer is incorrect. As defined in AU-C 935.11, one reason costs might be questioned by the auditor is that they appear unreasonable and do not reflect the actions of a prudent person (not specifically a member of management) under the circumstances.]

   d. They lead to material noncompliance. [This answer is incorrect. According to AU-C 935.11, noncompliance with the applicable compliance requirements is considered quantitatively or qualitatively material if there is a substantial likelihood that, individually or in the aggregate, it would influence the judgment made by a reasonable user of the report on compliance about the entity's compliance with the requirements of the government program as a whole. However, material noncompliance is not one of the red flags that lead to questioned costs, as that term is defined in the same standard.]

3. Under what circumstances might a HUD auditor need to perform tests of controls over applicable compliance requirements? **(Page 137)**

   a. Substantive procedures will provide sufficient appropriate audit evidence. [This answer is incorrect. AU-C 935.20 states that the auditor should perform tests of controls over each applicable service requirement if certain conditions apply. One such condition is that substantive procedures alone do *not* provide sufficient appropriate audit evidence.]

   b. The governmental agency provides outdated or conflicting guidance. [This answer is incorrect. If the audit guidance provided by a governmental agency has not been updated for, or otherwise conflicts with, current GAAS or *Government Auditing Standards,* AU-C 935.22 requires the auditor to comply with the most current applicable GAAS and *Government Auditing Standards*, rather than the outdated or conflicting guidance. In that situation, the auditor may want to consult with the governmental entity that established the audit guidance or provided the funding. However, this situation is not one that requires the performance of tests of controls.]

   c. Subsequent events occur that may affect the entity's financial statements. [This answer is incorrect. Subsequent events procedures should be performed up to the date of the auditor's report to obtain sufficient appropriate audit evidence that all subsequent events related to compliance during the period covered by the auditor's report on compliance have been identified. However, this is a separate consideration during the compliance audit and is not related to the decision about whether to perform tests of controls.]

   d. **They are required by the governmental audit requirement. [This answer is correct. According to AU-C 935.20, auditors should perform tests of controls over each applicable compliance requirement if any of three conditions applies. One of those conditions is when tests of controls over compliance are required by the governmental audit requirement. One example of this situation is if tests of controls are required by the HUD audit guide or the OMB's Uniform Guidance. Another condition that indicates that the auditor should perform tests of controls is when the risk assessment includes an expectation of the operating effectiveness of controls over compliance related to the applicable compliance requirement.]**

4. All of the following are common problems the HUD Office of Inspector General (HUD OIG) has found in audits of HUD-assisted projects **except**: **(Page 141)**

   a. Indirect costs charged to one project instead of multiple projects. [This answer is incorrect. One common problem found by the HUD OIG is many projects are operated by the same management entity, but all indirect costs are charged to a single project. In these instances, cost distributions were arbitrary and not supportable.]

   b. **Owners making withdrawals of the project's surplus cash. [This answer is correct. Though the HUD OIG has found common problems related to surplus cash in its audits of HUD-assisted projects, the fact that such withdrawals occur is not necessarily an issue. According to the HUD OIG, two common problems related to such withdrawals are (1) owners making cash withdrawals when the project was not in "surplus cash" position and (2) surplus cash withdrawn at other than allowed semiannual or annual fiscal periods.]**

   c. The lack of appropriate accounting procedures at the project. [This answer is incorrect. One common problem noted in OIG audits of HUD-assisted projects is when appropriate accounting procedures and controls were not established at the project.]

   d. Fees paid to management in unapproved amounts. [This answer is incorrect. In past years, the HUD OIG has found common problems in OIG audits of HUD-assisted projects, including management fees in excess of HUD-approved amounts.]

5. Why does the HUD OIG issue Program Fraud Alerts? **(Page 143)**

   a. To prohibit creative compensation arrangements with identity-of-interest companies. [This answer is incorrect. Some affiliates of HUD-assisted entities have established creative compensation arrangements involving identity-of-interest companies. However, such arrangements are not the focus of Program Fraud Alerts.]

   b. To address compliance issues with "new construction" programs. [This answer is incorrect. The Sections 202 and 811 "new construction" programs have attracted an eclectic group of sponsoring organizations ranging from local religious organizations to community organizations for the developmentally disabled. Auditors need to be aware that such organizations often lack an awareness of compliance issues. However, such programs and organizations are not the focus of Program Fraud Alerts.]

   c. **To address national trends involving housing fraud. [This answer is correct. "Program Fraud Alerts" are notices issued by the HUD OIG to address national trends in housing fraud. A Program Fraud Alert was issued to discuss violations of applicable statutes and HUD requirements involving equity skimming, for example.]**

   d. To address the effects of fewer personnel as the HUD downsizes. [This answer is incorrect. HUD continues to downsize, and with fewer personnel available to conduct inspection of project owners, HUD looks to auditors to be its "partner" in detecting noncompliance with HUD laws and regulations. However, while this is true, it is not related to the HUD OIG's issuance of Program Fraud Alerts.]

LAWS, REGULATIONS, AND OTHER MATTERS

This section discusses the following aspects of compliance auditing:

- Responsibility for laws and regulations in all audits.
- Responsibility for laws and regulations under *Government Auditing Standards*.
- Responsibilities under the HUD audit guide.
- Tests of compliance versus other audit tests.
- Transaction-related versus program-related requirements.
- Relating compliance audit procedures to financial audit procedures.

Responsibility for Laws and Regulations in All Audits

In an audit of the financial statements made in accordance with GAAS, the auditor's responsibilities concerning errors, fraud, and noncompliance with laws and regulations relate to their possible effect on the financial statements. AU-C 240.05 explains that the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement whether caused by fraud or error. AU-C 250.A10 clarifies that the auditor's responsibility for detecting misstatements resulting from noncompliance with laws and regulations that have a direct and material effect on the financial statements is the same as that for other errors and fraud. Further, AU-C 250 requires the auditor to perform specific procedures, including inquiry and inspection of correspondence with licensing or regulatory authorities, to identify potential noncompliance with laws and regulations that may have a material *indirect* effect on the financial statements.

Although outside the scope of this course, *PPC's Guide to HUD Audits* addresses the auditor's assessment of the risk of material misstatements and material noncompliance with laws and regulations in planning the audit.

Responsibility for Laws and Regulations and Other Matters under *Government Auditing Standards*

The HUD audit guide, the Single Audit Act of 1996, and OMB's Uniform Guidance require the auditor to follow *Government Auditing Standards* for financial audits. Paragraph 6.15 of the Yellow Book states that, in addition to the requirements in AU-C 240 regarding fraud and those in AU-C 250 regarding noncompliance with provisions of laws and regulations, the auditor "should extend the AICPA's requirements pertaining to the auditors' responsibilities for laws and regulations to also apply to consideration of compliance with provisions of contracts or grant agreements."

Waste and Abuse. The Yellow Book includes guidance regarding *waste* and *abuse*. The guidance on waste and abuse is included in the application guidance relating to findings. Paragraph 6.20 of the Yellow Book indicates that the auditor's evaluation of internal control in a government environment may also include considering internal control deficiencies that result in waste or abuse. Under the Yellow Book, auditors will consider findings relating to waste and abuse along with other findings.

<u>Definition of Abuse.</u> The concept of abuse is different from that of fraud or noncompliance. Paragraph 6.23 of the Yellow Book states:

> Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances, but excludes fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate.

Based on the Yellow Book's definition of abuse, what constitutes abuse or potential abuse is not clear and will be open to interpretation. Paragraph 6.24 of the Yellow Book provides the following examples of actions that may represent abuse, depending on the relevant facts and circumstances:

a. Creating unneeded overtime.

b. Requesting staff to perform personal errands or work tasks for a supervisor or manager.

c. Misusing the official's position for personal gain (including actions that could be perceived by an objective third party with knowledge of the relevant information as improperly benefiting an official's personal financial interests or those of an immediate or close family member; a general partner; an organization for which the official serves as an officer, director, trustee, or employee; or an organization with which the official is negotiating concerning future employment).

<u>Definition of Waste.</u> Like abuse, the concept of waste in the Yellow Book is different from that of fraud or noncompliance. Paragraph 6.21 of the Yellow Book states:

> Waste is the act of using or expending resources carelessly, extravagantly, or to no purpose. Importantly, waste can include activities that do not include abuse and does not necessarily involve a violation of law. Rather, waste relates primarily to mismanagement, inappropriate actions, and inadequate oversight.

Based on the Yellow Book's definition of waste, what constitutes waste or potential waste is not clear and will be open to interpretation. Paragraph 6.22 of the Yellow Book, provides the following examples of actions that may represent waste, depending on the relevant facts and circumstances:

a. Making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.

b. Making procurement or vendor selections that are contrary to existing policies or are unnecessarily extravagant or expensive.

Auditor's Responsibilities Relating to Waste and Abuse. Paragraph 6.20 of the Yellow Book provides the following:

> Because the determination of waste and abuse is subjective, auditors are not required to perform specific procedures to detect waste or abuse in financial audits. However, auditors may consider whether and how to communicate such matters if they become aware of them. Auditors may discover that waste or abuse are indicative of fraud or noncompliance with provisions of laws, regulations, contract, and grant agreements.

Auditors do not have a responsibility to detect waste and abuse under either GAAS or *Government Auditing Standards*. Under the Yellow Book, auditors will consider findings relating to waste and abuse along with other findings. If the auditors detect waste or abuse that are indicative of fraud or noncompliance, the auditor's responsibility is to consider whether and how to communicate the fraud or noncompliance to those charged with governance.

Abuse Relating to Federal Awards. 2 CFR section 200.516(a)(1) requires the auditor to report as audit findings significant instances of abuse relating to major programs. Because the Uniform Guidance requires that costs charged to federal awards be reasonable and necessary, Paragraph 10.51 of the GAS/SA Audit Guide indicates situations that may appear to be abuse are generally noncompliance instead.

Reporting Fraud and Noncompliance. *Government Auditing Standards* expands the requirements in GAAS to include misstatements resulting from noncompliance with the provisions of contracts or grant agreements that could have a material effect on financial statement amounts or other financial data significant to the audit objectives. Thus, in Yellow Book engagements, auditors have the same responsibilities for detecting material misstatements arising from violations of provisions of contracts or grant agreements as they do for detecting those arising from fraud and noncompliance with laws and regulations. The Yellow Book, Paragraph 6.53, has specific requirements for reporting known or likely fraud and noncompliance including requirements to report directly to outside parties in certain circumstances.

Paragraph 6.41 of the Yellow Book states that the auditor's report on internal control or compliance should include relevant information about:

- Noncompliance with provisions of laws, regulations, contracts, or grant agreements that has a material effect on the financial statements or other financial data significant to the audit objectives.

- Fraud that is material, either quantitatively or qualitatively, to the financial statements or other financial data significant to the audit objectives.

As indicated above, the threshold for reporting fraud and noncompliance with laws or regulations is the same for reporting noncompliance with contracts or grant agreements. Paragraph 6.44 of the Yellow Book states that the auditor should communicate in writing to audited entity officials the following situations even when immaterial:

- Identified or suspected noncompliance with provisions of laws, regulations, contracts, or grant agreements that comes to the auditor's attention during the course of an audit that has an effect on the financial statements or other financial data significant to the audit objectives that is less than material but warrants the attention of those charged with governance.

- The auditor has obtained evidence of identified or suspected instances of fraud that have an effect on the financial statements or other financial data significant to the audit objectives that are less than material but warrant the attention of those charged with governance.

Reporting to Those Charged with Governance and to Outside Parties. Paragraph 6.53 of the Yellow Book indicates that auditors are required to report to those charged with governance when management fails to respond appropriately to the auditor's findings of identified or suspected noncompliance with provisions of laws, regulations, contracts, and grant agreements and instances of fraud. The auditor may also be required to report the matters directly to outside parties. Paragraph 6.53 of the Yellow Book indicates that auditors should report directly to those charged with governance:

- Management's failure to report findings of fraud or noncompliance to external parties when required to do so by laws or regulations.

- Management's failure to respond in a timely and appropriate manner when findings of fraud on noncompliance are likely to have a material effect on the subject matter and involve funds received directly or indirectly from a government agency.

If, after the auditor's communication with those charged with governance, the entity's response is still inadequate, Paragraph 6.53 of the Yellow Book states that the auditor should communicate directly with outside parties as follows:

- The auditor should report relevant information directly to external parties if (a) the auditor has communicated to those charged with governance that management has not met legal or regulatory requirements to report fraud or noncompliance to specific external parties and (b) the entity does not report the findings as soon as practicable after this communication.

- The auditor should report relevant information directly to the funding agency if (a) the auditor has communicated to those charged with governance that management failed to take timely, appropriate actions to respond to findings of fraud or noncompliance that involves funding received directly or indirectly from the government agency that is likely to be material to the subject matter and (b) the entity does not take appropriate steps as soon as practicable after this communication.

In both of these situations, Paragraph 6.53 of the Yellow Book indicates that the auditor should obtain sufficient appropriate audit evidence (for example, by confirmation with outside parties) to support management's representation that it has reported such findings in accordance with laws, regulations, or funding agreements. If unable to do so, the auditor should report the findings. The above reporting requirements are in addition to any other legal requirements to report such findings directly to outside parties and are applicable even if the auditor has resigned or has been dismissed from the audit.

The auditor may also be required by laws, regulations, or policies to report indications of fraud, or noncompliance to authorities before performing additional audit procedures. Paragraph 6.12 of the Yellow Book requires auditors to evaluate the effect of initiated or in-process investigations or legal proceedings on the current audit. Paragraph 6.14 of the Yellow Book states that it may be appropriate for the auditors to work with investigators or legal authorities or to withdraw from or defer further work on the engagement or a portion of the engagement to avoid interfering with an ongoing investigation or legal proceeding.

The authors strongly recommend that the auditor consult with an attorney on the wording of the report on fraud, noncompliance, or possible acts noted. Such matters should also be reported as noncompliance in the appropriate reports required by the Uniform Guidance.

Additional Requirements in the HUD Audit Guide. When the auditor finds that fraud has occurred or is likely to have occurred, Paragraph 2-5 of the HUD audit guide directs the auditor to follow the communication and reporting requirements in the Yellow Book. If, as discussed later in this section, circumstances require the auditor to report to a funding agency (that is, HUD), the auditor is to direct the communication to the HUD OIG single audit coordinator. Paragraph 2-5 of the HUD audit guide goes further to state that because some HUD entities lack an appropriate governance structure, in some situations if the auditor were to report a potential fraud to those charged with governance, he or she would be reporting the fraud to the same persons responsible for the fraud. In that situation the auditor is directed by the HUD audit guide to report the matter directly to the HUD OIG single audit coordinator, preferably before leaving the audit site.

Presentation of Findings. The Yellow Book, at Paragraph 6.51, require auditors to report their findings in perspective by describing the extent of their work and the nature and extent of the matters being reported. When applicable, auditors should relate the findings to the population or the number of cases identified and quantify the results using dollar values or other measures. The presentation of the findings should include (a) the criteria against which performance is measured, (b) the condition that exists, (c) the cause of or reason for the condition, and (d) the effect or potential effect of the condition.

Effect on the Compliance Audit

As previously discussed, GAAS applicable to financial audits and the Yellow Book require only that the auditor test compliance with laws and regulations that could have a direct and material effect on the *financial statements*. The HUD audit guide, (for-profit audits), and the Single Audit Act Amendments and OMB's Uniform Guidance (nonprofit audits) require the auditor to follow GAAS and the auditing standards for financial audits contained in the Yellow Book. However, they go further and also require the auditor to test compliance with laws and regulations that could have a material effect on *each major federal award program*.

Paragraph 1-1 of the HUD audit guide requires the auditor to determine and report whether the entity has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each major program. For Single Audits, the Uniform Guidance [at 2 CFR sections 200.514(d) and 200.515(c)] uses different but equivalent terminology in the authors' opinion. The Uniform Guidance requires the auditor to determine and report whether the entity has complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each major program. *Material effect* means that noncompliance with laws and regulations could affect the allowability of material amounts for federal program expenditures. Thus, the auditor must perform enough testing of major programs to provide a sufficient basis for expressing an opinion on compliance related to each major program.

In order to express an opinion on the entity's compliance with requirements applicable to major programs, the auditor must test those programs with respect to the applicable compliance requirements. Identifying compliance requirements is discussed in Lessons 2 and 3.

In the compliance portion of a HUD audit, the auditor selects transactions charged to *each* major program and tests them for compliance with the applicable laws and regulations to support the auditor's opinion on compliance. Determining the nature and extent of the compliance tests is discussed in Lesson 2. When determining the extent of tests, the auditor assesses audit risk of noncompliance and materiality in relation to each HUD program being tested. Materiality is not measured in relation to a combined total for all HUD programs. The assessed level of materiality and size of the population is critical in determining the scope of the auditor's work and evaluating the results of audit procedures.

Tests of Compliance versus Other Audit Tests

The term *tests of compliance* refers to audit procedures designed to enable the auditor to obtain sufficient appropriate audit evidence about a client's compliance with applicable compliance requirements of HUD. Synonymous terms are "tests of compliance with laws and regulations" or "tests of compliance with requirements."

Tests of compliance are *substantive procedures* and are usually procedures of details as opposed to analytical procedures. A variety of audit procedures may be used in making tests of compliance including inquiry, observation, inspection of documents, and confirmation.

Transaction-related versus Program-related Requirements

Laws, regulations, and other contractual requirements may be either transaction-related or program-related. The distinction between those types of requirements is an important one for understanding aspects of a compliance audit and assessing how noncompliance findings may affect the financial statement audit.

Transaction-related Requirements. A transaction-related requirement applies only to individual transactions. The auditor determines whether the transaction is "allowable," that is, whether the types of goods or services that the entity purchased are allowable under HUD regulations.

Noncompliance with a transaction-related requirement may result in a disallowed cost. It is up to HUD to determine whether, in fact, a cost is disallowed. In the compliance audit, the auditor may identify instances of noncompliance in tests of transactions; these transactions are identified and reported by the auditor as *questioned costs*. A questioned cost is an amount spent by a recipient of HUD funds that may not be in compliance with requirements set forth in the regulatory agreement, statutes, or regulations governing allowability. A questioned cost may result in HUD's requiring that funds already expended be refunded. As discussed above, the auditor must assess all instances of noncompliance to determine the effect on the reports on compliance. Questioned costs are reported as an element of audit findings.

Because a questioned cost may have to be refunded to HUD, noncompliance with transaction-related requirements may have a material effect on the financial statements. Financial statement materiality is evaluated by the dollar amount of the questioned costs in relation to planning materiality. Thus, an important consideration in planning compliance tests of transaction-related requirements is the materiality of the HUD programs to the financial statements. Another important consideration is the auditor's assessment of the risk of noncompliance. Together those considerations determine the auditor's assessment of the risk of material misstatement of the financial statements resulting from noncompliance with transaction-related requirements.

The auditor's approach to tests of compliance with transaction-related requirements always involves selection of individual transactions and inspection of supporting documentation. The tests may involve use of audit sampling, as explained in Lesson 3.

Program-related Requirements. A program-related requirement involves an overall aspect of a HUD program rather than individual recorded transactions. In HUD engagements, program-related requirements include the following types of requirements:

- *Reporting*—requirements that specify the reports a project owner must file and additional requirements that apply to those reports.
- *Other General Matters*—requirements that identify certain particular laws or regulations that must be complied with as part of the regulatory agreement or housing assistance payments contract.

The materiality of noncompliance with program-related requirements to the financial statements depends on the particular requirements. The *reporting requirements* must usually be met for the entity to be entitled to the financial assistance; for example, the requirement to submit certifications of tenant incomes or HAP vouchers. Thus, in those cases, if the related HUD assistance is material to the financial statements, noncompliance could be material. *Other program-related requirements* are usually not directly material to the financial statements; however, the auditor would still assess whether noncompliance needs to be reported as audit findings.

Relating Compliance Audit Procedures to Financial Audit Procedures

Though outside the scope of this course, *PPC's Guide to HUD Audits* discusses procedures and considerations specific to designing and performing substantive audit procedures in an audit of an entity's basic financial statements as a part of the HUD audit. As noted previously, the components of a HUD audit include an audit of the financial statements and an audit of compliance with HUD requirements. The ideal approach to the HUD audit is to perform both parts of the audit simultaneously so that overall audit efficiency can be maximized.

Consideration needs to be given to the effects on the financial statement audit of any findings or questioned costs identified in the compliance audit. The auditor could also consider how the procedures performed in the compliance audit might contribute to the entity's financial audit. For example, if the auditor determines that testing controls to reduce the assessed level of control risk over a particular audit area is appropriate for the financial statement audit, the auditor may be able to reduce substantive tests of compliance in the compliance part of the audit for those areas in which controls have been determined to be effective. However, care needs to be exercised when attempting to use the results of audit tests in the financial part of the HUD audit to reduce testing in the compliance part of the audit because of the differences in the audit objectives. The auditor may also be able to reduce substantive tests of compliance if the tests of controls required by the HUD audit guide indicate that controls are effective and the control risk assessment can be reduced below high. (As discussed in Lesson 3, consideration also needs to be given to the HUD audit guide's requirements when sampling is used to test compliance requirements.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

6. The HUD audit guide, the Single Audit Act of 1996, and the OMB's Uniform Guidance require auditors to follow the Yellow Book for financial audits. What change does the Yellow Book make to GAAS in relation to noncompliance with laws and regulations that affect a HUD compliance audit?

    a. The auditor's responsibility for noncompliance relates only to their possible effect on the financial statements.

    b. The auditor's responsibility for noncompliance extends to provisions of contracts or grant agreements.

    c. The auditor's responsibility for detecting misstatements that result from noncompliance is the same as that for errors or fraud.

    d. The auditor is required to perform specific procedures to identify potential noncompliance.

7. The act of using resources extravagantly, carelessly, or for no defined purpose is called what?

    a. Abuse.

    b. Equity skimming.

    c. Noncompliance.

    d. Waste.

8. Which of the following statements describes a transaction-related requirement?

    a. This type of requirement relates to an overall aspect of a HUD program.

    b. This type of requirement may relate to reporting or various laws and regulations.

    c. Noncompliance with this type of requirement can result in a disallowed cost.

    d. Materiality is generally not important when dealing with this type of requirement.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

6. The HUD audit guide, the Single Audit Act of 1996, and the OMB's Uniform Guidance require auditors to follow the Yellow Book for financial audits. What change does the Yellow Book make to GAAS in relation to noncompliance with laws and regulations that affect a HUD compliance audit? **(Page 149)**

   a. The auditor's responsibility for noncompliance relates only to their possible effect on the financial statements. [This answer is incorrect. In an audit of the financial statements made in accordance with GAAS, the auditor's responsibilities concerning errors, fraud, and noncompliance with laws and regulations relate to their possible effect on the financial statements. Therefore, this is a GAAS requirement, not a Yellow Book requirement.]

   b. **The auditor's responsibility for noncompliance extends to provisions of contracts or grant agreements. [This answer is correct. The Yellow Book states that, in addition to the requirements in AU-C 240 regarding fraud and those in AU-C 250 regarding noncompliance with provisions of laws and regulations, the auditor "should extend the AICPA's requirements pertaining to the auditors' responsibilities for laws and regulations to also apply to consideration of compliance with provisions of contracts or grant agreements."]**

   c. The auditor's responsibility for detecting misstatements that result from noncompliance is the same as that for errors or fraud. [This answer is incorrect. AU-C 240.05 explains that the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement whether caused by fraud or error. AU-C 250.A10 clarifies that the auditor's responsibility for detecting misstatements resulting from noncompliance with laws and regulations that have a direct and material effect on the financial statements is the same as that for other errors and fraud. Therefore, this responsibility is outlined in GAAS, not the Yellow Book.]

   d. The auditor is required to perform specific procedures to identify potential noncompliance. [This answer is incorrect. AU-C 250 requires the auditor to perform specific procedures, including inquiry and inspection of correspondence with licensing or regulatory authorities, to identify potential noncompliance with laws and regulations that may have a material indirect effect on the financial statements. Therefore, this requirement comes from GAAS and not the Yellow Book.]

7. The act of using resources extravagantly, carelessly, or for no defined purpose is called what? **(Page 150)**

   a. Abuse. [This answer is incorrect. Paragraph 6.23 of the Yellow Book states, "Abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances, but excludes fraud and noncompliance with provisions of laws, regulations, contracts, and grant agreements. Abuse also includes misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate." This definition does not include the misuse of resources described above.]

   b. Equity skimming. [This answer is incorrect. Equity skimming is broadly defined in a HUD OIG Program Fraud Alert as "the misuse or diversion of project assets or income by project owners or management agents." This is a different concept than the issue related to resources described above.]

   c. Noncompliance. [This answer is incorrect. Under the Yellow Book, noncompliance refers to instances of entities not complying with provisions of laws, regulations, contracts, and grant agreements. That is different from the issues using resources described above.]

   d. **Waste. [This answer is correct. Paragraph 6.21 of the Yellow Book states, "Waste is the act of using or expending resources carelessly, extravagantly, or to no purpose. Importantly, waste can include activities that do not include abuse and does not necessarily involve a violation of law. Rather, waste relates primarily to mismanagement, inappropriate actions, and inadequate**

oversight." An example of waste would be making travel choices that are contrary to existing travel policies or are unnecessarily extravagant or expensive.]

8. Which of the following statements describes a transaction-related requirement? **(Page 153)**

   a. This type of requirement relates to an overall aspect of a HUD program. [This answer is incorrect. A program-related requirement involves an overall aspect of a HUD program rather than individual recorded transactions. A transaction-related requirement applies only to individual transactions.]

   b. This type of requirement may relate to reporting or various laws and regulations. [This answer is incorrect. In HUD engagements, program-related requirements, not transaction-related requirements, include those related to reporting (requirements that specify the reports a project owner must file and additional requirements that apply to those reports) and other general matters (requirements that identify certain particular laws or regulations that must be complied with as part of the regulatory agreement or housing assistance payments contract).]

   c. **Noncompliance with this type of requirement can result in a disallowed cost. [This answer is correct. Noncompliance with a transaction-related requirement may result in a disallowed cost. It is up to HUD to determine whether, in fact, a cost is disallowed.]**

   d. Materiality is generally not important when dealing with this type of requirement. [This answer is incorrect. Financial statement materiality is evaluated by the dollar amount of questioned costs in relation to planning materiality. Thus, an important consideration in planning compliance tests of transaction-related requirements is the materiality of the HUD programs to the financial statements.]

Lesson 2: Compliance Requirements and Related Considerations

INTRODUCTION

Lesson 2 discusses more issues related to HUD compliance audits, this time focusing on compliance requirements. It begins with a discussion of identifying compliance requirements, followed by one about the compliance auditor's consideration of internal control over compliance. Next, this lesson takes a look at auditing the HUD entity's compliance with compliance requirements and the audit procedures suggested by the HUD audit guide. Finally, Lesson 2 concludes with a discussion of specific compliance requirements that apply to for-profit HUD assisted projects and how to summarize and evaluate the results of compliance tests.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify compliance requirements that apply to a HUD-assisted entity and considerations of internal control over compliance.
- Recognize best practices for auditing a HUD-assisted entity's compliance with the compliance requirements, specific compliance requirements that apply to for-profit HUD-assisted projects, and summarizing and evaluating results of compliance tests.

HOW TO IDENTIFY COMPLIANCE REQUIREMENTS

The purpose of this section is to assist auditors in identifying compliance requirements applicable in audits of HUD-assisted entities. Sources of information include the HUD audit guide, the OMB Uniform Guidance, the *OMB Compliance Supplement*, federal statutes, the *Code of Federal Regulations*, contracts and award agreements (such as the regulatory agreement and HAP contract), HUD handbooks, and housing notices.

Management's Responsibilities

AU-C 935.14 specifically assigns management the responsibility for identifying government programs and understanding and complying with the programs' compliance requirements. The auditor is responsible for determining which of those programs and compliance requirements to test (i.e., the applicable compliance requirements). AU-C 935.A9 notes that while some governmental audit requirements identify applicable compliance requirements, other governmental audit requirements provide only a framework for determining the applicable compliance requirements.

Sources of Compliance Requirements

HUD Audit Guide. Chapter 3, "HUD Multifamily Housing Programs," of the HUD audit guide identifies compliance requirements applicable to for-profit entities that receive assistance under a HUD multifamily housing program. Although the HUD audit guide identifies compliance requirements, it is a summary. Auditors will *always* need to refer to the project-specific contracts and agreements governing the assistance such as the regulatory agreement and HAP contract and, in most cases, to the specific statutes and regulations cited in the guide. A detailed discussion of the compliance requirements appears later in this lesson.

OMB's Uniform Guidance. OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) establishes uniform cost principles and audit requirements for federal awards to nonfederal entities and administrative requirements for all federal grants and cooperative agreements. Auditors of nonprofit HUD-assisted entities must refer to the OMB's Compliance Supplement for the applicable compliance requirements to be tested in the Single Audit. Using the Compliance Supplement to identify the applicable compliance requirements is discussed in Lesson 3.

Enabling Statutes, Appropriations Acts, and Implementing Regulations. Every HUD program derives its authority from specific federal legislation enacted by Congress. Appropriations acts enacted separately—often years after initial authorization—actually fund the various programs. For example, the Section 8 rent subsidy program was authorized under housing statutes passed in 1937, but it was not until 1974 that an appropriations act made funds available under the Section 8 program.

Legislation authorizing housing programs and the related appropriations acts are merely the initial legal steps in activating a new program. HUD issues regulations to implement each program (commonly referred to as "implementing regulations") and publishes them in the *Code of Federal Regulations*. (The *Code of Federal Regulations* can be found on the Internet.) The nature of the topics addressed in implementing regulations varies from program to program but generally includes requirements that are unique to the program, for example, description of the types of projects that are eligible for assistance under the program, a description of the process the owner must follow to obtain financial assistance under the program, and ongoing reporting requirements.

Contracts and Agreements. HUD requirements specific to each HUD project are set forth in agreements signed by the project owner and HUD. From a compliance standpoint, the key documents are the regulatory agreements and, for projects that receive rent subsidies, housing assistance payments contracts. Exhibit 2-1 describes the contents of those documents in greater detail.

Exhibit 2-1

Regulatory Agreements and HAP Contracts

Regulatory Agreement

The contents of the regulatory agreement vary depending on the type of project but generally address the following areas:

- Owner's administrative duties and bookkeeping responsibilities.
- Owner's duty to maintain security deposit accounts, reserve for replacement funds, and residual receipts.
- Owner's right to make additions to the property.
- In the case of rent subsidized projects, tenant application, eligibility, and income certification procedures to be followed by the owner.
- No discrimination against families with children.
- No substitution of any general partner or management agent without HUD approval.
- No sale or conveyance of property without HUD approval.
- No distributions, except to the extent of surplus cash, and only under specific conditions.
- Prohibition against owner charging initial applicants more than one month's rent plus a security deposit.
- Project owner's duty to maintain property in good repair and condition.
- Records maintenance requirement and 90-day filing requirement for annual audit.
- Requirement to deposit project receipts in a federally insured financial institution.
- Agreement to comply with civil rights statutes.

Housing Assistance Payments Contract (HAP contract)

Project owners that receive rent subsidies sign Housing Assistance Payments Contracts (HAP contracts) with HUD. The HAP Contract generally includes the following:

- Agreement to market units in accordance with the Affirmative Fair Housing Marketing Plan and the regulations relating to fair housing advertising.
- Agreement to process applications and admit tenants only in accordance with HUD requirements.
- Agreement to provide decent, safe, and sanitary housing.
- Agreement to maintain an appropriate level of flood insurance.
- Agreement to comply with the requirements of the Clean Air Act and the Federal Water Pollution Control Act, if applicable.
- Agreement to abide by nondiscrimination requirements, including Section 504 of the Rehabilitation Act of 1973 and the Age Discrimination Act of 1975.
- Procedures for the owner's billing HUD for rent subsidies.
- Rules governing payments of rent subsidies to project owners.
- Number of units that HUD agrees to assist.
- Procedures for adjusting rents over the term of the HAP contract.
- Rules for paying owners for vacant units.

Other contracts and agreements may have compliance significance depending on the type of project, for example, an owner of a Section 811 capital advance project for the disabled signs a capital advance agreement with HUD.

HUD Handbooks and Interim Notices. HUD has been prolific in developing HUD handbooks, which describe the requirements faced by owners and agents in day-to-day project operations. Handbooks of greatest compliance significance are the following:

- HUD HB 4350.3 REV-1, *Occupancy Requirements of Subsidized Multifamily Housing Programs*. This handbook provides extensive coverage of leasing and occupancy requirements for rent subsidized projects. Coverage includes screening applicants for housing, eligibility requirements, tenant certification, leasing and security deposits, recertification of tenant income, termination of tenancy, and billing HUD for assistance payments.
- HUD HB 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*. This handbook contains procedures for depositing cash receipts and repaying owner advances.
- HUD HB 4350.1 REV-2, *Multifamily Asset Management and Project Servicing*. This handbook includes requirements for requesting withdrawals from the reserve fund for replacements.
- HUD HB 4370.1 REV-2, *Reviewing Annual and Monthly Financial Reports*. Describes the contents of monthly accounting reports required of some projects, for example, "Schedule of Accounts Payable" and "Schedule of Disbursements."
- HUD HB 4355.1 REV-1, *Flexible Subsidy*. This handbook includes procedures for requesting funds under HUD's flexible subsidy program.
- HUD HB 4381.5, REV-2, *Management Agent Handbook*. This handbook provides guidance regarding most aspects of HUD's relationship and interaction with owners and management agents of HUD-insured and HUD-assisted properties.

- HUD HB 8025.1 REV-2, *Implementing Affirmative Fair Housing Marketing Requirements*. This handbook provides guidance for the implementation of the Affirmative Fair Housing Marketing Regulations (24 CFR Part 200, Subpart M) and the preparation and implementation of AFHM Plans.

The handbooks represent HUD's interpretation of Congress' and federal regulators' intent and are nonauthoritative in the sense that they lack the authority of laws or regulations that have been exposed for public comment prior to issuance. Nevertheless, a long-standing perception held by many within the HUD organization that the handbooks are authoritative remains undiminished. The handbooks and transmittals of changes or revisions to the handbooks are available at **https://www.hud.gov/program_offices/administration/hudclips**.

Identifying the Requirements of Funding Sources Other Than HUD

Owners of HUD projects may receive assistance from other governmental departments or agencies (federal, state, or local governments). Among the assistance programs commonly associated with HUD-assisted projects are the following:

- Summer Jobs Programs under the U.S. Department of Labor.
- Agriculture Nutrition Programs under the U.S. Department of Agriculture.
- Development grants or loans from state governments.
- Grants or loans from state departments of energy.
- Funding for construction or housing assistance from city governments.

For non-HUD programs, the auditor needs to apply procedures to gain an understanding sufficient to design tests of compliance. The auditor typically discusses the compliance requirements with the project owner's chief financial officer. The auditor then reviews the grant or loan agreement (or other agreement) and discusses requirements with officials at the governmental agency. For federal programs, the auditor can also refer to the *Code of Federal Regulations* cited in the loan or grant agreement. Becoming familiar with the program requirements may also include reading the guidance in the Assistance Listing and the Compliance Supplement.

The HOME Program (Home Investments Partnership Program) is one example of a federal award program that impacts some HUD-assisted projects. Under this program, the state or local government generally grants or loans "bridge financing" to a nonprofit entity that enters into a contract with a syndicated partnership. However, the HUD audit guide does not address this type of award. In this case, the authors recommend that auditors perform a Yellow Book audit.

Similarly, many new HUD projects, such as Risk Sharing Programs and Section 223(f) programs, participate in the low-income housing tax credit (LIHTC) program. Tenants in these projects are subject to income determinations and other conditions for which noncompliance, in theory, could trigger recapture of the credit. While the low-income tax credit does not qualify as a federal award, auditors ought to at least consider whether compliance procedures should be performed when noncompliance could have a material impact on the financial statements.

Documenting Applicable Compliance Requirements

The auditor should document the types of compliance requirements that are applicable to the major program. In addition, the auditor should document the considerations supporting the decision as to which compliance requirements could have a direct and material effect on the program and therefore should be tested. Similar documentation considerations in Single Audits of nonprofit HUD-assisted entities are discussed in Lesson 3.

CONSIDERING INTERNAL CONTROL OVER COMPLIANCE

Obtaining an Understanding of Internal Control and Assessing Risk

Participants in HUD programs are required to maintain internal control over federal programs to provide reasonable assurance that the programs are managed in compliance with provisions of laws, regulations, contracts, or grant agreements that could have a material effect on each major program. Thus, in a HUD audit, the auditor is not only concerned with obtaining an understanding of internal control over financial reporting, as in all GAAS audits, but also with the internal control pertaining to the compliance requirements for each major program.

AU-C 315A requires the auditor to obtain a sufficient understanding of each of the five components of internal control to plan the audit. An in-depth discussion about procedures used to obtain the understanding of internal control and assess control risk in a HUD audit engagement is beyond the scope of this course, but more information is available in *PPC's Guide to HUD Audits*.

The auditor's consideration of internal control over compliance in a HUD audit is similar to the consideration of internal control over financial reporting in a financial statement audit. The same concepts apply regarding assessing risk, understanding internal control over compliance, and testing controls. However, the consideration of internal control in a HUD audit of compliance is directed toward compliance with provisions of laws, regulations, contracts, or grant agreements (or in a Uniform Guidance audit, federal statutes, regulations, and the terms and conditions of federal awards), and the applicable compliance requirements. Chapter 3 of the HUD audit guide contains the compliance requirements for HUD for-profit multifamily entities. The *OMB Compliance Supplement* provides the compliance requirements for nonprofit HUD-assisted entities.

AU-C 935.15 states the auditor should perform risk assessment procedures to obtain a sufficient understanding of the direct and material compliance requirements and related internal control over such compliance requirements for each program and compliance requirement selected for testing. AU-C 935.20 further states that the auditor should perform tests of controls over each applicable compliance requirement if tests of controls over compliance are required by the governmental audit requirement. Such a requirement exists in HUD audits. The HUD audit guide, at Paragraph 1-3(B), states the requirement as follows:

> . . . the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal controls in preventing or detecting material noncompliance with the direct and material requirements of the major HUD-assisted programs. *The auditor should perform these procedures regardless of whether the auditor assesses the internal control risk to be below the maximum.* [Emphasis added.]

Paragraph 9.13 of the GAS/SA Audit Guide provides guidance about obtaining an understanding of internal control over compliance. It explains that to obtain a sufficient understanding, the auditor should:

- Perform risk assessment procedures to evaluate the design of controls relevant to the compliance audit and to determine whether they have been implemented.
- Use the information gathered by performing the risk assessment procedures, including the audit evidence obtained in evaluating the design of controls and determining whether they have been implemented, as audit evidence to support the risk assessment.
- Use the risk assessment to determine the nature, timing, and extent of further audit procedures to be performed.

Paragraph 9.14 of the GAS/SA Audit Guide explains that controls used by entities may be the same for multiple federal programs and similar transactions (such as cash disbursements). Those controls will often provide assurance regarding the achievement of the compliance objectives related to transactions and assets of some or all federal programs. However, the use of the same controls does not eliminate the need for the auditor to obtain an understanding of internal control over compliance for each major program.

In order to obtain a sufficient understanding of internal control, the auditor needs to first identify, for each major program, which of the compliance requirements in Chapter 3 of the HUD audit guide (for-profit audits) or in the *OMB Compliance Supplement* (nonprofit audits) have a direct and material effect on the program. The auditor's assessment should be documented.

Evaluating the Design and Implementation of Compliance Controls

To identify controls relevant to HUD compliance requirements, the auditor should obtain an understanding of the five components of internal control relevant to the specific compliance requirements for each major program. In obtaining this understanding, the auditor should perform risk assessment procedures to evaluate the design of the controls and determine if the controls have been implemented. In evaluating the design of a control, the auditor considers whether the control, individually or in combination with other controls, is capable of effectively preventing or detecting and correcting instances of noncompliance. The auditor considers the design of the control when deciding whether to consider its implementation (i.e., whether the control exists and the entity is using it).

Procedures used to evaluate the effectiveness of the design of a control and its implementation might include (a) inquiries of entity personnel, (b) inspection of documents and reports, and (c) observation of the application of the specific controls. Performing only inquiry is not sufficient for evaluating the design of a control and determining whether it has been implemented.

Assessing Control Risk of Noncompliance

According to AU-C 935.15, the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and the related internal controls for each program and compliance requirement selected for testing. The auditor's understanding is then used to (a) identify and assess risk of material noncompliance and (b) determine the nature, timing, and extent of the compliance audit procedures (including the extent of testing the implementation of corrective actions). Thus, after obtaining an understanding of internal control over compliance for each major program, the auditor makes a preliminary assessment of control risk of noncompliance related to the compliance requirements for the program and uses the assessment to determine whether a low assessed level of control risk of noncompliance can be supported. If the auditor concludes that controls are capable of effectively preventing, or detecting and correcting, material noncompliance, control risk of noncompliance might initially be assessed at less than the maximum during the risk assessment phase of the compliance audit.

Determining Controls to Test

As noted previously, testing internal control over compliance is required in the compliance audit portion of a HUD audit regardless of whether the auditor tests controls in the financial statement audit. Accordingly, not all controls that may be relevant to the financial statements or the financial reporting system would need to be tested. When determining which controls to test, the auditor does the following:

- Gains an understanding of the compliance requirements subject to audit for each major program included in the Compliance Supplement and the applicable compliance requirements for each major program not included in the Compliance Supplement.
- Determines which compliance requirements subject to audit have a direct and material effect on each major program.
- Determines the applicable controls for those compliance requirements.
- Determines what controls are in place to prevent or detect material noncompliance.
- Documents and plan tests of those controls to support the assessed level of control risk of noncompliance for major programs. (OMB's Compliance Supplement provides suggested audit procedures for testing internal control in a Single Audit.)

The requirement to obtain an understanding of, plan, and test internal control over compliance applies only to internal controls relevant to major programs. It does not apply to activities unrelated to major programs. This requirement to test compliance controls is not relative to any efficiency decision by the auditor. It is *required* even if the auditor has excluded the effect of controls from the relevant risk assessment for the audit of the financial statements for efficiency reasons. Accordingly, not all controls that may be relevant to the financial statements or the financial reporting system would need to be tested for the compliance audit. Also, the auditor performs tests of controls over compliance with major programs of for-profit entities regardless of whether the auditor assesses the internal control risk at high in the audit of the financial statements.

The auditor may plan for a low assessed level of control risk and test compliance controls based on that plan. However, a low assessed level of control risk may not be achieved. If deviations in the tests of compliance controls are found, additional selections would not have to be tested. The auditor would only need to report the results of the testing and perform compliance testing based on assessing the control risk at the level actually achieved, either high (or moderate) depending on the sample size and number of deviations found. If, however, the control testing supports assessing the control risk at less than high (either low or moderate), the auditor may consider reducing the substantive testing of compliance accordingly.

Ineffective Internal Control. In some situations, planning for and performing tests of controls to support a low assessed level of control risk of noncompliance may not be appropriate. When the auditor has determined that internal control over compliance for some or all of the compliance requirements for a major program have not been implemented or are likely to be ineffective in preventing or detecting noncompliance, the auditor is not required to plan or perform tests of the internal control over compliance to support a low assessed level of control risk for the relevant assertions. The auditor would report the internal control deficiency as a significant deficiency or a material weakness in internal control over compliance in the schedule of audit findings. In audits of for-profit entities, the auditor should consider assessing control risk at the maximum, and whether additional compliance tests are necessary due to ineffective internal control. In Single Audits of nonprofit entities conducted under the Uniform Guidance, the auditor *must* report a significant deficiency or material weakness in internal control over compliance, assess control risk at the maximum, and consider whether additional compliance tests are necessary.

Auditors need to be cautious about not planning and performing tests of internal control because of identified weaknesses. If internal control over some of the major program compliance requirements may be functioning, appropriate tests should be made. For example, if the auditor has determined that there is a pervasive internal control weakness, such as a lack of segregation of duties, that would not be a reason to eliminate testing of other controls that may be in place, such as having someone determine eligibility of individuals to receive federal rental assistance.

The auditor's assessment of the effectiveness of internal control over compliance in preventing, detecting, and correcting noncompliance is determined in relation to an individual type of compliance requirement subject to audit that could have a direct and material effect on a major program. For example, if a lack of segregation of duties causes controls over compliance with requirements for eligibility to be ineffective, the auditor would:

- Report the lack of segregation of duties relative to eligibility as a significant deficiency or a material weakness in internal control over compliance.
- Assess control risk of noncompliance related to eligibility requirements at the maximum.
- Consider the lack of effective control when designing the nature, timing, and extent of procedures to test compliance with the major program's eligibility requirements. In most cases, the extent of testing would need to be expanded.

Using Results of Prior Years' Tests of Controls. The results of prior years' tests of compliance controls can provide important information to consider when planning current year tests of compliance controls. If the results of prior tests of controls prevented the auditor from assessing a low level of control risk of noncompliance, the auditor might decide to expand testing in the current audit period. Useful information also might be obtained by testing changes in internal control that were intended to eliminate deficiencies noted in the previous year. However, if the auditor concluded in the prior year that internal control over compliance for one or more compliance requirements was ineffective and the auditee has not made changes in its internal control over compliance, the auditor might conclude that controls are likely to be ineffective. In this situation, the auditor could choose not to plan and perform tests of compliance controls and should report a significant deficiency or a material weakness in internal control over compliance, as discussed above. (Lesson 3 provides additional considerations in the year the Uniform Guidance is implemented for a Single Audit of a nonprofit HUD entity.)

Using Compliance Audit Testwork to Reduce Testwork in the Financial Statement Audit. The auditor may also consider how the testwork necessary for performing the compliance audit might contribute to the financial statement audit. For example, an entity may have one internal control process for handling payroll transactions. If the auditor tests the controls over payroll as part of the compliance audit, the auditor could consider that testwork when determining what additional tests of controls or other substantive procedures are necessary as part of the financial statement audit. As long as the compliance audit requirements are met and compliance audit procedures are documented separately from procedures related to the financial statement audit, this may allow the auditor to be more efficient and maximize the audit evidence obtained from the tests of compliance controls.

Performing Tests of the Operating Effectiveness of Controls

The HUD audit guide provides no specific guidance on performing tests of the design or operating effectiveness of controls over compliance. Generally accepted auditing standards make the following points:

- Procedures directed toward evaluating the design of a control ordinarily include inquiries of appropriate entity personnel, inspection of documents and reports, observation of the application of specific controls, and tracing transactions through the information system relevant to financial reporting. Inquiry alone is not sufficient. (AU-C 315A.14 and AU-C 315A.A76–.A77)
- Tests of the operating effectiveness of controls are performed only on controls the auditor has determined are suitably designed to prevent or detect a misstatement in a relevant assertion. (AU-C 330.A21)
- Tests of the operating effectiveness of a control are concerned with how the control (whether manual or automated) was applied, the consistency with which it was applied during the audit period, and by whom it was applied. (AU-C 330.10)
- Tests of the operating effectiveness of a control ordinarily include procedures such as inquiries of appropriate personnel; inspection of documents, reports, or electronic files indicating performance of the control; observation of the application of the control; and reperformance of the application of the control. (AU-C 330.A28)
- Some of the procedures performed to evaluate the design of controls and determine that they have been implemented may also provide audit evidence about the operating effectiveness of the controls. (AU-C 330.A23)
- Generally, IT processing is inherently consistent. For this reason, procedures performed to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness. (AU-C 315A.A78)
- The auditor should perform other audit procedures in combination with inquiry to test the operating effectiveness of controls. (AU-C 330.A28)
- The nature of a control influences the type of audit procedure necessary to obtain evidence about its operating effectiveness. If documentation of the operation of a control exists, the auditor might inspect the documentation. If documentation of the operation does not exist, the auditor might obtain audit evidence about the control's operating effectiveness through inquiry in combination with other audit procedures such as observation or the use of CAATs. (AU-C 330.A29)
- Controls should be tested for either a particular time or throughout the period, depending upon the circumstances. For example, when testing controls over a year-end physical inventory count, the auditor needs audit evidence of the control's operating effectiveness only at that period of time. (AU-C 330.11 and AU-C 330.A35)

The guidance described in the previous paragraph is written from the perspective of a financial statement audit; however, it is generally applicable when testing internal control over compliance. AU-C 935, which explains how GAAS is adapted and applied in a compliance audit, provides additional guidance on tests of controls. AU-C

935.19–.20 requires the auditor to design and perform further audit procedures in response to the assessed risks of material noncompliance. Such procedures should include performing tests of controls over compliance if any of the following conditions are met:

- The auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance for the compliance requirements that will be tested.
- Substantive procedures alone do not provide sufficient appropriate audit evidence.
- Tests of controls over compliance are required by the governmental audit requirement.

AU-C 935.A25 further clarifies that some governmental audit requirements (such as the HUD audit guide and the Uniform Guidance) require tests of the operating effectiveness of controls identified as likely to be effective, even if the auditor believes that such testing would be inefficient.

Auditors of HUD entities need to be alert for evidence of control effectiveness that can be obtained from external sources, such as external program reviews. For example, the Section 8 administrator performs annual reviews of Section 8 projects, in which tenant files and subsidy vouchers are examined, specific units are visited, and the waiting list and tenant selection plans are reviewed. This external evidence can assist the auditor in assessing the effectiveness of the HUD entity's controls. However, it cannot be relied upon to eliminate the performance of appropriate audit procedures. Also, audit evidence gained from testing internal control over compliance in prior years would not be applicable when conducting the compliance audit under the HUD audit guide because the auditor must obtain sufficient, appropriate evidence about the effectiveness of compliance controls every year.

AU-C 330.09 provides guidance about the extent of tests of controls; it states that the greater the reliance placed on the effectiveness of a control, the more persuasive the audit evidence the auditor should obtain from designing and performing tests of the control. AU-C 330.A31 further states it may be appropriate to increase the extent of testing of a control when more persuasive audit evidence regarding the effectiveness of the control is needed.

The GAS/SA Audit Guide, Paragraph 9.39, states that in a compliance audit, and assuming an understanding that controls are effective, the auditor should design and perform tests of controls to obtain sufficient appropriate audit evidence that the controls are operating effectively for each compliance requirement subject to audit that is direct and material throughout the period of reliance. In doing so, the auditor might consider the following factors (AU-C 330.A31):

- The frequency with which the control is performed during the period.
- The length of time that the auditor is relying on the control's operating effectiveness.
- The expected deviation from the control.
- The relevance and reliability of the audit evidence about the operating effectiveness of the control with respect to the type of compliance requirement being considered.
- The extent to which audit evidence is obtained from tests of other controls related to the type of compliance requirement.

Paragraph 9.39 of the GAS/SA Audit Guide indicates that, when designing and performing tests of internal controls over compliance, the auditor should obtain more persuasive audit evidence when the auditor plans to place greater reliance on the operating effectiveness of a control. The extent of internal control testing should also increase as the expected deviation increases. However, the auditor should consider whether the rate of expected deviation indicates that performing tests of controls will not provide sufficient audit evidence to reduce the control risk of noncompliance for the assertions relevant to the compliance requirement. If the rate of expected deviation for a particular type of compliance requirement is expected to be high, the auditor might determine that tests of controls are inappropriate.

Sampling in Tests of Internal Controls Over Compliance

Lesson 3 discusses the use of sampling for tests of controls, including factors that influence sample size.

Evaluating the Results of Tests of Controls

The GAS/SA Audit Guide provides useful guidance for assessing the results of tests of internal control over compliance. Paragraph 9.47 of the GAS/SA Audit Guide explains that the auditor should evaluate whether the assessment of the risk of material noncompliance for the relevant compliance requirements remains appropriate based on the audit procedures performed related to controls and the audit evidence obtained. The audit evidence may cause the auditor to modify the nature, timing, or extent, of other planned audit procedures because information coming to the auditor's attention may differ significantly from the information on which the risk assessments were based.

Before the conclusion of the audit, the auditor should evaluate whether audit risk of noncompliance has been reduced to an appropriately low level, and whether the nature, timing, and extent of the audit procedures need to be reconsidered. The auditor should conclude whether sufficient appropriate audit evidence has been obtained to reduce the risks of material noncompliance to an appropriately low level. In developing an opinion on compliance, the auditor should consider all relevant audit evidence, regardless of whether it appears to corroborate or to contradict the relevant assertions.

Paragraph 9.48 of the GAS/SA Audit Guide indicates that in situations where auditors cannot support a low assessed level of control risk of noncompliance for a direct and material compliance requirement subject to audit that is direct and material, they are not required to expand their testing of internal control over compliance for that compliance requirement. Instead, they may choose not to perform additional tests of controls. In which case, the auditor would (a) assess control risk of noncompliance at other than low, (b) design appropriate tests of compliance based on that assessment, and (c) consider reporting an audit finding. If auditors decide to expand their testing of internal control over compliance, their decision would be based on whether they consider the additional internal control testing to be more efficient than performing additional tests of compliance. Auditors may consider whether, based on the testing performed, control risk of noncompliance might be assessed at less than maximum to reduce substantive tests of compliance. If it cannot be assessed at less than the maximum, it might be more appropriate to assess control risk of noncompliance at the maximum.

It is natural for there to be some deviations in the way controls are applied. A control that has a non-negligible deviation rate is, at minimum, a deficiency in internal control over compliance, regardless of the reason for the deviation. (Control deficiencies are discussed below.) When deviations are detected during the performance of tests of controls, the auditor should make specific inquiries to understand the deviations and their potential consequences. In addition, the auditor should consider whether any noncompliance detected from performing substantive procedures changes his or her judgment about the effectiveness of the related controls. The auditor also should not assume that an instance of fraud or error is an isolated occurrence, and should consider how it affects the assessed risk of material noncompliance.

Because effective controls can reduce but not eliminate risks of material noncompliance, tests of controls can reduce but not eliminate the need for substantive procedures in compliance tests. Therefore, the auditor should design and perform substantive procedures for all relevant assertions related to the compliance requirements subject to audit that are direct and material for each major program.

Tests of compliance may provide evidence that either supports the auditor's conclusion about the operating effectiveness of controls or creates a need to reevaluate the prior assessment of control risk of noncompliance. The GAS/SA Audit Guide, Paragraph 9.52, states that the auditor should consider the results of tests of compliance when evaluating the operating effectiveness of internal control over compliance. Noncompliance detected by the auditor that was not identified by the entity is evidence of a deficiency in internal control over compliance and might indicate a significant deficiency or a material weakness in internal control over compliance. On the other hand, a test of compliance that does not detect noncompliance does *not* provide audit evidence that controls related to a compliance requirement are effective.

Control Deficiencies. A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance with a type of compliance requirement on a timely basis. The auditor should evaluate the severity of each deficiency in internal control over compliance to determine whether the deficiency, individually or in combination, is a significant deficiency or material weakness in internal control over compliance. The severity of a deficiency depends on the magnitude of potential noncompliance and whether there is a reasonable possibility that the entity's controls will fail to prevent, or detect and correct, noncompliance with a type of compliance requirement.

The GAS/SA Audit Guide, Paragraph 9.60, explains that the evaluation of deficiencies in internal control over compliance includes the magnitude of potential noncompliance. (Note that the auditor considers the *potential* for noncompliance, not whether noncompliance has occurred. The absence of identified noncompliance does not indicate that control deficiencies are not significant deficiencies or material weaknesses in internal control over compliance.) The auditor should evaluate individual control deficiencies that affect the type of compliance requirement, or component of internal control, to determine if they collectively result in a significant deficiency or material weakness in internal control over compliance because a combination of control deficiencies that affect the same type of compliance requirement increases the risks of material noncompliance.

The definitions of *significant deficiency in internal control over compliance* and *material weakness* in a compliance audit as established by AU-C 935.11 are as follows:

- *Material weakness in internal control over compliance.* A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis.
- *Significant deficiency in internal control over compliance.* A deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance.

Reporting Responsibilities

When auditors report on internal control over compliance for federal programs, they should consider the definitions of a significant deficiency in internal control over compliance and a material weakness in internal control over compliance.

For compliance audit purposes, significant deficiencies and material weaknesses related to internal control over compliance and material noncompliance with provisions of laws, regulations, contracts, or grant agreements are to be considered as they relate to the applicable compliance requirements for *each major program* or to an audit objective. The controls that auditors are concerned with are those that relate to assuring compliance or, in other words, preventing noncompliance. Accordingly, auditors need to evaluate significant deficiencies and material weaknesses relative to the levels of materiality considered for the related major programs.

The objective of the consideration of internal control is not to reduce the extent of substantive audit tests based on the effectiveness of control activities, but to report on internal control. Although the HUD audit guide, the Single Audit Act, and the Uniform Guidance require a report on the internal control over major federal programs, they do not require the auditor to express an opinion on internal control.

In addition to the report described in the preceding paragraph, the auditor needs to follow the GAO's Yellow Book. The Yellow Book requires a report on internal control in relation to the audit of the financial statements. This means that the auditor must disclose any significant deficiencies and material weaknesses identified during the financial statement audit as a result of the consideration of internal controls or any other audit tests. Accordingly, the schedule of audit findings should include disclosure of significant deficiencies and material weaknesses at the financial statement level and at the major program level.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. A Housing Assistance Payments Contract (HAP contract) would generally include which of the following?
   a. An agreement to provide housing at a certain square footage.
   b. An agreement to abide by nondiscrimination requirements.
   c. An agreement not to substitute management agents without HUD approval.
   d. An agreement not to advertise available units.
10. Doing which of the following will help an auditor determine which of a HUD-assisted project's internal controls to test in a compliance audit?
    a. Determine what compliance requirements have a direct and material effect on each major program.
    b. Make a list of all controls relevant to the financial reporting system so that all can be tested.
    c. Exclude compliance requirements related to major programs not included in the Compliance Supplement.
    d. Obtain an understanding of the five components of internal control.
11. Which of the following guidance applies when testing the design or operating effectiveness of a HUD-assisted entity's controls over compliance?
    a. Guidance in the HUD audit guide takes precedence over generally accepted auditing standards.
    b. Tests of operating effectiveness should be performed on controls that are randomly selected.
    c. Due to their relative inconsistency, extra tests are needed to test the operating effectiveness of automated IT controls.
    d. The nature of a control will influence the type of procedure the auditor uses to test its operating effectiveness.
12. When the design or operation of a control over compliance does not allow the entity to prevent or detect and correct noncompliance during the normal course of business on a timely basis, which of the following exists?
    a. A deficiency in internal control over compliance.
    b. A significant deficiency in internal control over compliance.
    c. A material weakness in internal control over compliance.
    d. A test of compliance.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

9. A Housing Assistance Payments Contract (HAP contract) would generally include which of the following? **(Page 160)**

   a. An agreement to provide housing at a certain square footage. [This answer is incorrect. HAP contracts generally include an agreement to provide decent, safe, and sanitary housing, but square footage is not typically included in that agreement.]

   b. **An agreement to abide by nondiscrimination requirements. [This answer is correct. Project owners that receive rent subsidies sign HAP contracts with HUD. Such contracts generally include certain agreements and other stipulations, including an agreement to abide by nondiscrimination requirements, including Section 504 of the Rehabilitation Act of 1973 and the Age Discrimination Act of 1975.]**

   c. An agreement not to substitute management agents without HUD approval. [This answer is incorrect. Regulatory agreements for HUD-assisted entities vary depending on the type of project but generally address certain specific areas. One of those areas is no substitution of any general partner or management agent without HUD approval. However, a HUD-assisted entity's regulatory agreements are different from HAP contracts and focus on different items.]

   d. An agreement not to advertise available units. [This answer is incorrect. Typically, a HAP contract includes an agreement to market units in accordance with the Affirmative Fair Housing Market Plan and the regulations relating to fair housing advertising. HUD-assisted entities that have HAP contracts are not prohibited from advertising.]

10. Doing which of the following will help an auditor determine which of a HUD-assisted project's internal controls to test in a compliance audit? **(Page 164)**

   a. **Determine what compliance requirements have a direct and material effect on each major program. [This answer is correct. Testing internal control over compliance is required in the compliance audit portion of a HUD audit regardless of whether the auditor tests controls in the financial statement audit. There are several actions that can help the auditor determine which controls to test, including determining which compliance requirements subject to audit have a direct and material effect on each major program, and the applicable controls for those compliance requirements.]**

   b. Make a list of all controls relevant to the financial reporting system so that all can be tested. [This answer is incorrect. Not all controls that may be relevant to the financial statements or the financial reporting system will need to be tested. Therefore, the auditor will need to determine which controls he or she should test.]

   c. Exclude compliance requirements related to major programs not included in the Compliance Supplement. [This answer is incorrect. When determining which controls to test, the auditor should, among other things, gain an understanding of the compliance requirements subject to audit for each major program included in the Compliance Supplement *and* the applicable compliance requirements for each major program not included in the Compliance Supplement.]

   d. Obtain an understanding of the five components of internal control. [This answer is incorrect. To identify controls relevant to HUD compliance requirements, the auditor should obtain an understanding of the five components of internal control relevant to the specific compliance requirements for each major program. This will help the auditor evaluate the design and implementation of compliance controls, and, thus, should be done in a HUD compliance audit. However, determining which controls to test is a different consideration with different associated actions that this course recommends compliance auditors take.]

11. Which of the following guidance applies when testing the design or operating effectiveness of a HUD-assisted entity's controls over compliance? **(Page 166)**

    a. Guidance in the HUD audit guide takes precedence over generally accepted auditing standards. [This answer is incorrect. The HUD audit guide provides *no* specific guidance on performing tests of design or operating effectiveness of controls over compliance. Generally accepted auditing standards, however, provide guidance HUD compliance auditors can use in this situation.]

    b. Tests of operating effectiveness should be performed on controls that are randomly selected. [This answer is incorrect. According to AU-C 330.A21, tests of the operating effectiveness of controls are performed only on controls the auditor has determined are suitably designed to prevent or detect a misstatement in a relevant assertion. Randomly selected controls would not fulfill this requirement.]

    c. Due to their relative inconsistency, extra tests are needed to test the operating effectiveness of automated IT controls. [This answer is incorrect. Per AU-C 315A.A78, generally, IT processing is inherently consistent. For this reason, procedures performed to determine whether an automated control has been implemented may serve as a test of that control's operating effectiveness. Additional tests would typically not be needed.]

    d. **The nature of a control will influence the type of procedure the auditor uses to test its operating effectiveness. [This answer is correct. As discussed in AU-C 330.A29, the nature of a control influences the type of audit procedure necessary to obtain evidence about its operating effectiveness. If documentation of the operation of a control exists, the auditor might inspect the documentation. If documentation of the control does not exist, the auditor might obtain audit evidence about the control's operating effectiveness through inquiry in combination with other audit procedures such as observation or the use of CAATs.]**

12. When the design or operation of a control over compliance does not allow the entity to prevent or detect and correct noncompliance during the normal course of business on a timely basis, which of the following exists? **(Page 169)**

    a. **A deficiency in internal control over compliance. [This answer is correct. A *deficiency in internal control over compliance* exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent or detect and correct noncompliance with a type of compliance requirement on a timely basis.]**

    b. A significant deficiency in internal control over compliance. [This answer is incorrect. As defined in AU-C 935.11, a *significant deficiency in internal control over compliance* is a deficiency, or a combination of deficiencies, in internal control over compliance that is less severe than a material weakness in internal control over compliance, yet important enough to merit attention by those charged with governance. The definition above is not as specific as this one; therefore, there is a better answer choice.]

    c. A material weakness in internal control over compliance. [This answer is incorrect. As discussed in AU-C 935.11, a *material weakness in internal control over compliance* is a deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. This definition is more severe than the one outlined above, so there is a better answer to this question.]

    d. A test of compliance. [This answer is incorrect. The term *tests of compliance* refers to audit procedures designed to enable the auditor to obtain sufficient appropriate audit evidence about a client's compliance with applicable compliance requirements of HUD. Tests of compliance might reveal the situation described above, but they are a different term entirely.]

ENSURING COMPLIANCE WITH COMPLIANCE REQUIREMENTS

Relationship of Compliance Tests to Internal Control Over Compliance

HUD regulations are usually concerned with all of a project owner's controls relating to the receipt of HUD funds, safeguarding project assets, and administration of HUD programs. Thus, they are concerned with both the design and the operating effectiveness of all relevant controls used in ensuring compliance with laws, regulations, and contractual requirements of the regulatory agreement and other governing documents.

The controls relevant to ensuring compliance with HUD requirements are important factors in assessing the risk of noncompliance and designing effective compliance tests. The auditor should perform risk assessment procedures to obtain a sufficient understanding of the compliance requirements subject to audit that are direct and material and related internal control over such compliance requirements for each program and compliance requirement selected for testing. Paragraph 6.30 of the GAS/SA Audit Guide explains that obtaining an understanding of each major program, the direct and material compliance requirements, and internal control over compliance establishes a frame of reference within which the auditor plans the compliance audit and exercises professional judgment for identifying and assessing the risks of material noncompliance and responding to those risks throughout the compliance audit.

In applying audit procedures to obtain sufficient, appropriate evidence about compliance with laws and regulations in a HUD audit, the number, selection, and testing of transactions is based on the auditor's professional judgment, professional standards, and the guidance in the governmental audit requirement (that is, the HUD audit guide or OMB's Uniform Guidance).

Tests of Compliance

Compliance testing includes tests of transactions and other auditing procedures necessary to provide the auditor sufficient evidence to report on compliance. Supporting an opinion on compliance for each major program requires testing of each major program. To accomplish this, Paragraph 1-1 of the HUD audit guide (for-profit audits), directs the auditor to Chapter 3 of the HUD audit guide for procedures for auditing compliance with HUD program requirements. For nonprofit HUD audits, the Uniform Guidance directs the auditor to the Compliance Supplement. The auditor should gain an understanding of the applicable compliance requirements in the compliance audit sufficient to determine the nature, timing, and extent of audit procedures necessary to provide the auditor with sufficient evidence to support an opinion on compliance for each major program.

Compliance testing includes tests of transactions and other auditing procedures as considered necessary to support an opinion on compliance. Because of the small population involved or the type of evidence available, the auditor may find that certain compliance requirements do not lend themselves to transaction testing. In those cases, the requirements are usually tested by inquiry, observation, and inspection. Other requirements, however, leave documentary evidence of compliance and involve large populations (e.g., requirements related to eligibility and allowable costs/cost principles). These requirements will generally be tested using transaction testing.

Selecting Transactions to Test. The selection of transactions for testing is based on the auditor's professional judgment. The auditor might apply a variety of approaches, such as:

- 100% testing.
- Testing individually important items.
- Analytical procedures.
- Sampling.

The attribute sampling methodology is required when the suggested procedures for testing compliance in the HUD audit guide require sampling. Lesson 3 discusses audit sampling in performing tests of compliance.

<u>100% Testing.</u> An efficient and effective audit approach in many circumstances may be to examine every item in a population relating to a compliance requirement for a major program. An important efficiency consideration is whether tests of compliance can be performed without using audit sampling. Sometimes an auditor can test 100% of

a population. This might be the case, for example, if the entire population consists of individually important items. The key to determining whether this approach is appropriate is a careful consideration of materiality, audit risk, the relationship of items or amounts tested to the account or program, and requirements of the HUD audit guide or OMB's Uniform Guidance.

Selecting Individually Important Items to Test for Compliance. The auditor might identify for each major program a few large or unusual items that are individually important and test them separately. (This is similar to the concept of individually significant items in a financial statement audit.) *Individually important items* are those that, standing alone, are significantly different from the rest of the population, for example, increased activity around a certain time period, such as journal entries made at the beginning or end of the year. The identification of individually important items can be a useful tool in determining the nature and extent of compliance audit procedures. Testing individually important items may result in a reduced sample size for the items remaining in a sampling population, or it might eliminate sampling altogether because it targets the items that have the greatest impact on noncompliance. (However, it cannot eliminate sampling when required in the compliance procedures in the HUD audit guide.)

The GAS/SA Audit Guide, Paragraph 11.22, explains that the auditor's use of judgment and experience when examining a population for risky or unusual transactions might be more effective in identifying noncompliance than randomly or haphazardly selecting a sample to test. It further explains that testing individually important items might reduce detection risk of noncompliance because the items the auditor decides to test are not part of the population subject to audit sampling.

Testing individually important items in a population may result in a reduced sample size for the items remaining in the sampling population, or it might eliminate sampling altogether because it targets those items that have the greatest impact on noncompliance. For example, if 80% of a program's expenditures could be examined by testing the 10 largest expenditures, detection risk may be reduced enough that the level of assurance needed from a sample of the remaining 20% of untested items will be lower. The GAS/SA Audit Guide, Paragraph 11.20, explains that instead of applying sampling to the remaining items in the population, the auditor might either apply other auditing procedures (such as scanning) to the remaining items, or apply no auditing procedures because there is an acceptably low risk of material noncompliance in the remaining items. The auditor is not using sampling in these two situations. Rather, the auditor has divided the population into two groups, one that is tested 100% and another that is either tested by other auditing procedures or is not tested.

Analytical Procedures. In circumstances when the auditor assesses that there is not an acceptably low risk of material noncompliance in the remaining items after testing individually important items, the auditor may be able to use analytical procedures rather than sampling the remaining items. However, the nature of many specific compliance requirements related to major programs is such that the auditor often obtains only minimal assurance from analytical review procedures. In evaluating whether analytical procedures provide sufficient appropriate audit evidence, the auditor should consider the risk of material noncompliance of the remaining balance and the effectiveness of those analytical procedures. The auditor needs to balance the persuasiveness of the audit evidence produced by analytical procedures with the assessment of the risk of material noncompliance of the remaining balance (i.e., the consideration of audit risk).

Sampling. When audit risk on the remaining balance after consideration of individually important items and analytical procedures has not been reduced to an acceptably low level, sampling is usually necessary. Also, sampling is *required* in many of the compliance audit procedures required by the HUD audit guide and the Compliance Supplement.

The auditor will often use sampling in addition to testing individually important items in the compliance portion of the HUD audit. Sampling is also used in testing program-related compliance requirements which typically relate to populations that do not have individually important items. In audits of for-profit HUD entities, the HUD audit guide provides other specific guidance for using sampling in tests of the guide's compliance requirements. Some of the compliance requirements in Chapter 3 of the HUD audit guide specify that sampling should be used when applying that guide's suggested audit procedures. Paragraph 3-1 discusses how auditors may use a "group project-based" sample to enhance audit efficiency. Group project-based sampling is discussed later in this section. Lesson 3 discusses the use of sampling for compliance tests in more detail, including factors that influence sample size.

Exhibit 2-2 is a list of compliance requirements that typically are not tested using audit sampling and compliance requirements that typically are tested using audit sampling.

Exhibit 2-2

Auditing Compliance Requirements in Chapter 3 of the HUD Audit Guide by Using Audit Sampling—For-profit Audits

Compliance Requirements That Typically Are Not Tested Using Audit Sampling

Compliance requirements that typically are not tested using audit sampling (i.e., nonsampling requirements) include:

- Mortgage Status
- Residual Receipts
- Distributions to Owners
- Equity Skimming
- Unauthorized Change of Ownership/Acquisition of Liabilities
- Unauthorized Loans of Project Funds
- Mark-to-Market Program (M2M)

Compliance Requirements That Typically Lend Themselves to Testing by Audit Sampling

Compliance requirements that lend themselves to testing by audit sampling typically include those that relate to activities or transactions that can be quantified.

- Federal Financial Reports[a]
- Replacement Reserve[a]
- Cash Receipts[a]
- Cash Disbursements[a]
- Tenant Application, Eligibility, and Recertification[a, b]
- Units Leased to Extremely Low-income Families[a]
- Tenant Security Deposits[a, b]
- Management Functions[a, b]
- Excess Income[a]
- Leased Nursing Homes
- Section 236 Decoupling Projects

Notes:

[a] Certain suggested audit procedures for testing compliance with the requirements in Chapter 3 of the HUD audit guide specifically direct the auditor to use sampling in the tests for this compliance area.

[b] The auditor may use a group project-based sample in the tests for this compliance area.

Tests of Compliance with Requirements Applicable to Major Programs

Tests of compliance with requirements applicable to major programs are substantive tests. Paragraph 1-3(B) of the HUD audit guide (for-profit audits) indicates the auditor should test internal control over compliance regardless of whether the auditor assesses the internal control risk for the assertions relevant to the compliance requirements for each major program to be below the maximum. 2 CFR section 200.514(c) (nonprofit audits) requires the auditor to plan the testing of internal control over compliance for major programs to support a low assessed level of control risk for the assertions relevant to the compliance requirements for each major program. Such testing would include evaluating the design and operating effectiveness of internal control over compliance for each direct and material compliance requirement for each major program.

The auditor's assessment of control risk of noncompliance (the risk that noncompliance with a compliance requirement that could occur and that could be material to a major program, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance) contributes to the auditor's evaluation of the risk that material noncompliance exists in a major HUD program. That assessment, together with the auditor's assessment of inherent risk and fraud risk, also provides audit evidence concerning the risk that material noncompliance may exist. This audit evidence becomes part of the basis for the auditor's opinion on compliance. As a result, the auditor's control risk assessment is an important factor in determining the extent of compliance tests.

Paragraph 11.11 of the GAS/SA Audit Guide states that the auditor uses the knowledge gained in the inherent risk of noncompliance assessment process to (a) identify types of potential noncompliance, (b) to consider other factors that affect the risk of material noncompliance, and (c) to design appropriate tests of compliance. The results of tests of controls impact the substantive tests of compliance that are necessary to provide the auditor with sufficient appropriate audit evidence to support an opinion on compliance for each major program. Effectiveness of controls is one factor that the auditor considers in deciding the number of transactions to test for compliance.

Paragraph 10.40 of the GAS/SA Audit Guide explains that in a compliance audit, the auditor must perform tests of transactions and such other auditing procedures necessary to provide sufficient appropriate audit evidence to support an opinion on compliance for each major program. Tests of compliance may be performed (a) concurrently with tests of the operating effectiveness of controls, (b) as separate substantive testing, or (c) as a combination of the two. In performing such tests, the auditor attempts to obtain reasonable assurance that the entity complied, in all material respects, with program compliance requirements. Because of factors such as auditor judgment, the use of sampling, and the inherent limitations of internal control over compliance, as well as the fact that much of the evidence available to the auditor is persuasive instead of conclusive in nature, the auditor can obtain reasonable, but not absolute, assurance about compliance.

Developing audit procedures for compliance testing requires designing procedures to detect both intentional and unintentional noncompliance. As discussed in Lesson 1, many of the compliance audit procedures in Chapter 3 of the HUD audit guide are aimed at detecting intentional noncompliance. However, it is important to remember that procedures that are effective for detecting unintentional noncompliance might not be effective for detecting noncompliance that is intentional and concealed through collusion between the entity's personnel and a third party or among the management or other employees of the entity. Thus, the subsequent discovery that material noncompliance with compliance requirements subject to audit that are direct and material exists does not, in and of itself, provide evidence of inadequate planning, performance, or judgment by the auditor.

Group Project-based Sampling—Audits of For-profit HUD Entities

Applicable Compliance Areas. Chapter 3 of the HUD audit guide allows the auditor to treat for-profit entities with common ownership and/or management as part of a common population for the purpose of testing certain compliance requirements. If a HUD-assisted for-profit entity is owned and/or managed by an entity that owns and/or manages many HUD-assisted entities, the auditor may use group project-based sampling, as described in the HUD audit guide, to test compliance with the following compliance areas:

- Tenant Application, Eligibility, and Recertification.
- Tenant Security Deposits.

- Management Functions.

Group project-based sampling may *only* be used for testing the compliance areas listed above. All other compliance requirements are to be tested separately for each individual HUD-assisted project.

Conditions for Use. The HUD audit guide, at Paragraph 3-1, states the following conditions must exist in order to use group project-based sampling:

a. The same system must be used by management for the applicable compliance area for all HUD-assisted entities selected for inclusion in the group project-based sample.

b. For the entities that are to be included in the population and sample, the compliance area must have the same supervisor for all projects, the procedures followed must be identical, and the test of internal controls over compliance must not have disclosed any internal control weaknesses; for example, significant deficiencies or material weaknesses.

c. The owner(s) must agree to the group project-based sample method.

d. The auditor must fully document the above information upon which the determination was made, including the owner's signed agreement.

If the auditor uses group project-based sampling on any or all of the three eligible compliance areas, compliance tests must be performed on each individual entity for all other applicable compliance areas.

A representative from the HUD Office of Inspector General provided some clarifying comments about applying the group project-based sampling method during a webcast sponsored by the AICPA's Governmental Audit Quality Center (GAQC) in November 2008. With respect to condition b. listed above, the "same supervisor" for all projects means the person at the project, regional, or corporate level that is responsible for seeing that a function is accomplished. It does not necessarily mean the direct supervisor of the person who carries out the function. The HUD official also clarified that problems with controls over the compliance requirements in the HUD audit guide are the types of internal control weaknesses that would prelude using group project-based sampling. The auditor initially may be aware of internal control weaknesses from previous audits or from the results of HUD management reviews and conclude group project-based sampling is not appropriate. The auditor also may become aware of internal control weaknesses as a result of testing internal controls over compliance during the audit. Depending on the significance of the weaknesses, the auditor may have to consider whether group project-based sampling is still appropriate.

Group Project-based Sample Selection. The HUD audit guide requires that the *greater* of the following number of entities be tested each year as a minimum sample for compliance testing:

- 20% of the entities in the population.
- Four HUD-assisted entities.

As a result, each entity in the population will be chosen for compliance testing at least once every five years.

The HUD audit guide, at Paragraph 3-1 provides the following examples to illustrate these requirements:

- *Example 1.* An auditor has 50 projects in the population that are to be audited, and the conditions permit the auditor to use group project-based sampling. The auditor would test 20% of the population, or 10 projects, since this amount is greater than four.
- *Example 2.* An auditor has 10 projects in the population that are to be audited, and the conditions permit the auditor to use group project-based sampling. The auditor would test the minimum of four projects since 20% of the population would only be two projects.

The auditor may increase the group project-based sample to include specific projects from the population based on his or her risk analysis or for any other reason. However, if a specific project is added for compliance testing, it cannot be counted as a part of the 20% or minimum sample size of four for that year. The auditor may also choose to audit any project that is eligible to be part of the group project-based sample on a stand-alone basis. The auditor may wish to do this, for instance, if the risk analysis leads the auditor to conclude there are isolated compliance or internal control problems at a particular project and the auditor wishes to use group project-based sampling for other projects under the same ownership or management.

Documentation Requirements. As previously mentioned, the HUD audit guide includes documentation requirements as a condition for allowing the auditor to use group project-based sampling. One of the purposes of the documentation is to allow the auditor to ensure that all entities in the population will continue to be audited systematically. In addition, AU-C 230, *Audit Documentation*, requires auditors to identify in the workpapers the items tested. The authors recommend the use of sampling summary sheets for each sampling application to document the key factors involved in the sampling application.

Impact on HUD Reporting Requirements. Applying group project-based sampling to test some or all of the three eligible compliance requirements for an entity does not change the HUD audit guide's compliance reporting requirements. When reporting on specific requirements applicable to major programs under the provisions of the HUD audit guide, the objective is to express an opinion on whether the entity has complied with laws and regulations that may have a direct and material effect on each major program. That is, even when group project-based sampling is used, the auditor's opinion on compliance is provided for each individual project, and the compliance testing must support the opinion for each individual project and not the group as a whole.

Prior to allowing group project-based sampling, HUD expected auditors to test each entity individually, even when managed by a common management agent. By allowing this sampling method, auditors can now view all entities managed by a common management agent as a single population under certain conditions. This allows the auditor to spread the sample across the entities being tested in the current year. For example, if the auditor decides to sample 25 tenant files to test the Tenant Application, Eligibility, and Recertification compliance requirement, those 25 tenant files would be allocated to the entities (minimum of four) being tested that year. This provision will provide relief for auditors that previously would have selected a sample of 25 items for each entity managed by a common management agent. However, there is no corresponding reduction in the auditor's reporting responsibilities.

If a condition of noncompliance or internal control weakness that is required to be reported is found during compliance testing, it must be reported in the report on major program compliance for each entity in the population. Reference to the finding should be made in each of the auditor's reports that contain that type finding. For example, a significant deficiency would be required to be included in the audit reports on major program compliance for all of the entities that were grouped for the group project-based population. If an audit finding is required to be reported and dollars are involved, only the dollars belonging to that specific entity should be included in that entity's schedule of findings, questioned costs, and recommendations.

Additionally, the HUD audit guide requires that nonmaterial instances of noncompliance must be reported in writing for each individual entity; either in a management letter or some other written correspondence for each entity in the population. The form and date of that communication must be included in the auditor's report on compliance.

THE HUD AUDIT GUIDE'S COMPLIANCE REQUIREMENTS AND SUGGESTED AUDIT PROCEDURES

The HUD audit guide, Chapter 3, identifies specific compliance requirements, followed by suggested compliance audit procedures for testing the for-profit multifamily entity's compliance with HUD program requirements. Paragraph 1-1 of the HUD audit guide observes:

> The use of this audit guide is mandatory for audits of all for-profit participants; however, this guide is not intended to be a complete manual of audit procedures for the compliance audit. The audit guide is not intended to cover all situations that may exist or replace the auditor's judgment of audit work required to meet GAAS and GAGAS. It is meant to supplement those standards with information specific to HUD programs. Suggested audit procedures contained herein might not cover all circumstances or conditions encountered in a particular audit. The auditor should use professional judgment to tailor the procedures so that the audit objectives are met. *However, auditors must address all compliance requirements in this audit guide that could have a direct and*

> *material effect on a major HUD-assisted program.* If the auditor determines that certain procedures for a compliance requirement will not be performed, the rationale for the exclusion must be explained and documented in the audit documentation in support of the auditor's report. An example would be a situation in which circumstances pertaining to the auditee are such that the auditee is not subject to a particular requirement. [Emphasis added.]

Paragraph 1-1 of the HUD audit guide goes on to provide instructions to the auditor about the importance of staying current with requirements that could affect the audit:

> Auditors should recognize that compliance requirements change periodically and that delays will occur between such changes and revisions to this audit guide. Moreover, auditors should recognize that there may be provisions of contracts and grant agreements that are not specified in law, regulation, or other HUD requirements contained in HUD handbooks, notices, and mortgagee letters; therefore, the specifics of such are not included in this audit guide. Accordingly, the auditor should perform reasonable procedures to ensure that compliance requirements are current and to determine whether there are any additional provisions of contracts and grant agreements that should be covered by an audit under this audit guide. Reasonable procedures would be inquiry of auditee management and review of the contracts and grant agreements for major programs. HUD documents are available in the HUD Client Information and Policy System (HUDCLIPS), at the following Internet address: **https://www.hud.gov/program_offices/administration/hudclips**.

COMPLIANCE REQUIREMENTS SPECIFICALLY APPLICABLE TO FOR-PROFIT HUD-ASSISTED PROJECTS

Paragraph 1-1 of the HUD audit guide states that the HUD audit guide is intended to assist auditors in performing audits of profit-motivated entities that are subject to HUD's Uniform Financial Reporting Standards (UFRS). As previously noted, although the HUD audit guide is not a complete manual of audit procedures, the auditor must address all of the compliance requirements in the guide that could have a direct and material effect on a major program. Chapter 3 of the HUD audit guide contains the procedures for auditing for-profit multifamily entities' compliance with the applicable HUD program requirements. The compliance requirements discussed in this section apply to HUD-assisted projects owned by for-profit project owners.

Auditors of nonprofit HUD-assisted entities consult the OMB's Compliance Supplement for applicable compliance requirements. Lesson 3 provides an overview of a compliance audit performed in accordance with the Uniform Guidance (that is, a Single Audit).

Elimination of Reporting Requirements for Nonmajor Programs and Fair Housing and Non-discrimination

HUD issued a revision of Chapter 2 of the HUD audit guide in January 2013 that made a significant change in the scope of the auditor's reporting responsibilities with respect to the compliance portion of a HUD audit. The revision of Chapter 2 of the HUD audit guide eliminated the previous requirement for the auditor to report on compliance with specific requirements applicable to *nonmajor* HUD programs. This means the auditor is not required to provide an opinion on compliance with program requirements with respect to nonmajor programs. However, as pointed out in a footnote to paragraph 2-4(C) of the HUD audit guide, the auditor is still required to consider the Yellow Book's requirements when instances of noncompliance that could have a material effect on the financial statements are found in nonmajor programs.

The revision of Chapter 2 of the HUD audit guide that was issued in January 2013 also eliminated the previous requirement for the auditor to issue a separate report on compliance with specific requirements applicable to fair housing and non-discrimination. Although this change eliminated one of the reports the auditor was required to issue as part of the HUD audit, it did not eliminate the compliance requirement itself. Chapter 3 of the HUD audit guide still provides suggested audit procedures for testing compliance with the fair housing and non-discrimination compliance requirement. However, informal guidance from a representative of the HUD OIG indicates the agency does not expect the auditor to include testing of this compliance area when opining on major program compliance.

Specific Compliance Requirements

The HUD audit guide contains the compliance requirements that are required to be addressed for each major HUD program in an audit under the HUD audit guide. According to Chapter 3 of the HUD audit guide, the following specific compliance requirements apply in audits of for-profit multifamily HUD-assisted entities:

a. Federal Financial Reports

b. Fair Housing and Non-discrimination

c. Mortgage Status

d. Replacement Reserve

e. Residual Receipts

f. Distributions to Owners

g. Equity Skimming

h. Cash Receipts

i. Cash Disbursements

j. Tenant Application, Eligibility, and Recertification

k. Units Leased to Extremely Low-income Families

l. Tenant Security Deposits

m. Management Functions

n. Unauthorized Change of Ownership/Acquisition of Liabilities

o. Unauthorized Loans of Project Funds

p. Excess Income

q. Leased Nursing Homes

r. Mark-to-Market Program (M2M)

s. Section 236 Decoupling Projects

The following paragraphs discuss the compliance requirements and suggested audit procedures for testing compliance with those requirements.

Federal Financial Reports

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.A.1, states that the compliance requirement for federal financial reports is as follows:

> Projects are required to ensure that financial status reports contain reliable financial data and are presented in accordance with the terms of applicable agreements between the project and HUD. The individual agreements contain the specific reporting requirements that the project must follow. HUD will usually require monthly reports whenever annual financial reviews, on-site reviews, or other information indicates that the project is experiencing financial or management difficulties or the owner/agent is suspected of noncompliance (HUD Handbook 4370.1, Chapter 3). The type of annual statements can vary by program. HUD Handbooks 4370.2 and 4350.1 provide detailed guidance as to which owners must submit financial statements and the types of statements that are required.

Compliance Audit Procedures. Procedures for testing the project owner's compliance with the "Federal Financial Reports" specific requirement should be performed. In essence, the auditor's task is to (a) identify the types of reports the entity must file and (b) determine that the entity filed those reports on a timely basis and filled out the forms correctly.

Exhibit 2-3 lists the types of federal financial reports applicable to HUD-assisted entities. The auditor can determine which of those reports apply to a particular entity through discussions with the project owner and management agent, by reading the regulatory agreement, and, for subsidized projects, by reading the HAP contract or similar contracts.

Exhibit 2-3

Types of Federal Financial Reports

Monthly Accounting Reports

Monthly accounting reports may be required under specific program requirements, during the initial rent up period, or for financially troubled projects. Some HUD offices may request that the project owner submit them under other circumstances. Monthly accounting forms that may be used include the following:

- Form HUD-93104, "Monthly Report of Excess Income."
- Form HUD-93479, "Monthly Report for Establishing Net Income."
- Form HUD-93480, "Schedule of Disbursements."
- Form HUD-93481, "Schedule of Accounts Payable."

"Budget Worksheet" (Form HUD-92547-A)

> The budget worksheet must be submitted by project owners that use a "budget based" approach to applying for a rent increase.

"Quarterly Performance Report" (Form HUD-9824-A)

> The "Quarterly Performance Report" includes "actual vs. budget" operating comparisons for the past quarter and estimated repair and replacement expenditures for the current quarter. [The report is required in the Flexible Subsidy program and is discussed in HUD Handbook 4355.1, "Flexible Subsidy," Paragraph 6-2(A).]

Instances of noncompliance that auditors frequently encounter in the area of federal financial reports include the following:

a. Reports are not filed in a timely manner.
b. The financial data reported is inconsistent with amounts included in the project owner's underlying records.
c. The "Monthly Report of Excess Income" (Form HUD-93104) is prepared incorrectly.
d. HAP vouchers are not adjusted for tenants who have moved in or out when billing HUD for the rent subsidy.

Fair Housing and Non-discrimination

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.B.1., states that the compliance requirement for fair housing and nondiscrimination is as follows:

> Owners and management agents are prohibited from discriminatory practices in accepting applications, renting units, and designating units or sections of a project for renting to prohibited bases in accordance with the Fair Housing Act and the provisions of the regulatory agreement.

The entity is required to market the project in accordance with a document called the "Affirmative Fair Housing Marketing Plan (AFHM Plan)." The AFHM Plan is an owner-prepared document that is submitted to and approved by HUD on Form HUD-935.2A. The AFHM Plan describes how groups of persons ordinarily not likely to apply for residency at the project will feel welcome to apply and have the opportunity to rent. In it, the entity describes the methods that will be used to attract all segments of the eligible population, especially those in the housing marketing area that are "least likely to apply without special outreach."

The AFHM Plan is required for most, but not all, HUD-assisted projects. The most common exception is a refinancing that takes place pursuant to Section 223(f) and/or 232/223(f) and is processed via the Multifamily Accelerated Processing Program (MAP). The regulatory agreement for entities refinanced via MAP provides for owner compliance of the Fair Housing Act, but MAP does not specifically require the AFHM Plan. HUD Handbook 4350.3 REV-1 provides guidance about updating the AFHM Plan at Paragraph 4-12 (F). The entity must review the plan at least every five years, and either submit a revised plan to HUD for approval, or document the review and why no change is required.

The entity also is required to select housing applicants in a nondiscriminatory manner, that is, without regard to the applicant's race, color, religion, sex, disability, family status, or national origin. However, when selecting among applicants for housing, certain preferences must apply and others may apply as described in HUD Handbook 4350.3 REV-1, Paragraph 4-6. Preferences do not affect applicant eligibility. It only affects their order on the waiting list. All applicants must be informed of the available preferences and be given a chance to qualify themselves under the preferences.

- *Statutory Preference—Displacement.* Owners of Section 221(d)(4), 221(d)(3) and 221(d) BMIR properties *must* give preference to applicants who have been displaced by government action or a presidentially declared disaster.
- *HUD Regulatory Preferences.* Owners of Section 236 properties *must* give preference to applicants who have been displaced by government action or a presidentially declared disaster. Owners of Section 236 Projects with rental assistance payments are subject to a "ranking" criteria unique to the program as described in Paragraph 4-6B.2.b. of HUD Handbook 4350.3 REV-1.
- *State and Local Preferences.* Entities *may* apply preferences based on state or local laws if they are consistent with HUD and applicable civil rights requirements, and with advance approval by HUD.
- *Owner-adopted Preferences.* Entities may adopt the following additional preferences (some of which require advance approval by HUD):
  - Residency.
  - Working family.
  - Disability.
  - Victims of domestic violence.
  - Single persons groups (such as elderly, displaced, homeless, or disabled).

As previously discussed, Change-2 to HB 4530.3 REV-1 added requirements for preventing discrimination affecting Limited English Proficient Persons (LEP). Under these revisions, entities must take reasonable steps to ensure meaningful access to the information and services they provide for persons with LEP. This may include interpreter services and/or written materials translated into other languages. In addition, the owner's responsibility to market projects to those least likely to apply includes marketing to the LEP population in the community.

Entities are permitted to establish and apply written screening criteria to determine whether applicants will be suitable tenants. This screening criteria must be included in the tenant selection plan and must be applied uniformly to all applicants, including live-in aides of applicants. HUD Handbook 4350.3 REV-1, Paragraph 4-7, specifies the screening criteria. The written screening criteria must prohibit the admission of applicants who have engaged in drug-related behavior, are subject a state lifetime sex offender registration program, or have abused alcohol so that it interferes with other residents. HUD has very specific guidelines governing what project owners can do when selecting and rejecting applicants for housing, and what they cannot do. Those guidelines are commonly referred to as "permitted rejection criteria" and "prohibited screening criteria." Under the *permitted rejection criteria*, project owners are not precluded from rejecting applicants for the following reasons (among others):

- Poor credit history.
- Minimum income requirements in the Section 236 and Section 221(d)(3) BMIR with no other assistance.
- Poor rental history.
- Unhealthy housekeeping habits.

Under the *prohibited screening criteria* set forth in Paragraph 4-8 of HUD Handbook 4350.3 REV-1, entities are prohibited from establishing criteria that:

- Is discriminatory.
- Requires medical evaluation or treatment.
- Requires purchase of meals or other services.
- Requires a donation or contribution.
- Inquires about the tenant's disabled status.
- Is prohibited by state or local laws.

The discussion above applies to owners of HUD-assisted projects subject to HUD Handbook 4350.3 REV-1. Owners of HUD-insured projects that are not subject to HUD Handbook 4350.3 REV-1 are still subject to the provisions of the Fair Housing Act and applicable state and local law.

Auditors should also be familiar with the entity's responsibilities toward disabled persons under Section 504 of the Rehabilitation Act of 1973 and the Fair Housing Act (FH Act). According to HUD Handbook 4350.3 REV-1, Paragraphs 2-8 and 2-44, project owners must do the following:

- Make and pay for reasonable structural modifications to units and common areas, unless they create an undue financial and administrative burden on the project owner.
- Operate housing to prevent segregation based on disability (unless authorized by federal statutes or orders and to promote integration).
- Provide auxiliary aids and services that are necessary to communicate with disabled persons.
- Develop a transition plan to ensure structural changes made to meet accessibility requirements.
- Perform a self-evaluation to ensure disability discrimination does not exist.
- Allow tenants with disabilities to use "service animals," for example, guide dogs, if the animal performs necessary assistance.

HUD Handbook 4350.3 REV-1, at Paragraph 2-5(c) discusses the applicability of the "reasonable accommodations" provisions of the Fair Housing Act (the Act) and Section 504 of the Rehabilitation Act of 1973 to owners of HUD-assisted projects. One type of disability discrimination prohibited by the Act is the refusal to make reasonable accommodations in rules, policies, practices, and services when such accommodations may be necessary to afford a person with a disability the equal opportunity to use and enjoy a dwelling. [See 42 USC 3604(f)(3)(B).] HUD's website provides additional information about reasonable accommodations at **www.hud.gov/program_offices/fair_housing_equal_opp/reasonable_accommodations_and_modifications** In addition, see 24 CFR Part 100 (especially 100.203 and 100.24). Auditors should consider whether or not their clients who own *market-rate* apartments are in compliance with the reasonable accommodations rules.

Compliance Audit Procedures. Chapter 3 of the HUD audit guide describes the suggested audit procedures to test compliance with the fair housing and nondiscrimination compliance requirements, beginning with applying audit procedures to the project's HUD-approved AFHM Plan. Procedures for testing the project owner's compliance with the "Fair Housing and Non-Discrimination" specific requirement should be performed.

The procedures pertaining to the fair housing and non-discrimination are designed to enable the auditor to determine whether the owner is screening and rejecting applicants in accordance with HUD's requirements. Some of the suggested procedures are coordinated with compliance tests for other compliance areas because the same sample is used to test more than one compliance area. It is a best practice to incorporate these efficiencies when allowed in the HUD audit guide. The auditor may gain additional efficiencies by performing tests of controls simultaneously with the tests of compliance.

The audit guidance set forth above is specifically applicable to HUD-assisted entities subject to HUD Handbook 4350.3 REV-1. Project owners who own "market-rate" apartments are *not* subject to the "prescriptive" documentation requirements regarding "move-ins" and "rejected applicants." Accordingly, there is not a comparable "paper trail" subject to audit. Nonetheless, the overarching provisions of the Fair Housing Act still apply to those entities, and auditors need to make appropriate inquiries regarding management's knowledge of the relevant Fair Housing laws and regulations, and management's system of internal control to assure compliance with those laws and regulations.

Considerations for Omitting Tests of the Fair Housing and Non-discrimination Compliance Requirement. As discussed earlier, the January 2013 revision to Chapter 2 of the HUD audit guide eliminated the previous requirement for the auditor to report *separately* on compliance with specific requirements applicable to fair housing and non-discrimination. Although the requirement to report separately on compliance with specific requirements applicable to fair housing and non-discrimination was eliminated, the compliance requirement itself has not been eliminated from the current version of Chapter 3 of the HUD audit guide. This raises the question of whether HUD expects the auditor to include the fair housing and non-discrimination compliance requirement when providing an opinion on major program compliance. The authors are aware that although HUD currently has no plans to issue formal guidance on the matter, a representative of the agency has indicated HUD does not expect the auditor to provide an opinion on compliance with fair housing and non-discrimination requirements.

Accordingly, if the auditor decides to eliminate any of the audit procedures discussed earlier that are designed to test compliance with HUD's fair housing and non-discrimination rules, the reasons for the decision need to be documented. However, the authors believe when HUD rental assistance under Section 8 is a major program, consideration should be given to testing compliance with fair housing and non-discrimination in the entity's tenant selection plan.

Mortgage Status

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.C.1., states that the compliance requirement for mortgage status is as follows:

> Owners shall promptly make all payments due under the note and mortgage.

The entity is required to repay loans (or capital advances) in accordance with the loan agreement (or capital advance agreement). It is the authors' opinion that the compliance requirement also applies to HUD's flexible subsidy program. The compliance requirements for the mark-to-market restructuring program (M2M) are discussed later in this section.

Compliance Audit Procedures. Procedures for testing the entity's compliance with the "Mortgage Status" specific requirement should be performed. Suggested audit procedures may include optional steps when the entity has a mortgage that has been assigned to HUD. Because failure to comply with the following requirements could subject the owner of the HUD-assisted entity to civil and criminal penalties, the authors believe the auditor needs to determine that:

a. The owner pays all costs of reasonable and necessary improvements to restore and upgrade the project.

b. The owner remits to HUD any cash remaining after the improvements have been paid for.

c. Until the mortgage is current, the project does not make distributions to owners or repay funds advanced by project owners, or repay principal or interest on a project obligation that is junior to the HUD mortgage.

Replacement Reserve

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.D.1., states that the compliance requirement for the replacement reserve is as follows:

> Owners, if required, shall establish a reserve for replacement account and make deposits in accordance with HUD requirements, usually the regulatory agreement or business agreement. The reserve for replacement account is usually required to be under the control of the lender. Disbursements from the reserve for replacement fund may be made only after written consent is received from HUD.
>
> Reserve for replacement funds are to be invested in interest-bearing accounts for certain projects. Interest earned on these projects is required to be maintained in the reserve for replacement account. For other projects, HUD strongly encourages owners to invest the reserve for replacement funds. The mortgagee is authorized to invest funds in excess of $100,000 (the Federal Deposit Insurance Corporation federally insured limit) in approved securities and/or financial institutions as long as it follows the requirements in HUD Handbook 4350.1, Paragraph 4-22. Interest on those investments is considered entity funds and may not be disbursed directly to owners or directly to any individual associated with the entity. All interest must flow through the entity accounts and be disclosed in the accounting records.

The owner is responsible for establishing a reserve fund for making necessary repairs and replacements of project property. The replacement reserve must be placed in an interest bearing account if the project is a new construction or substantial rehabilitation project for which the project owners received their notice of funds reservation on or after November 5, 1979, and February 20, 1980, respectively. Though HUD Handbook 4350.1 (Paragraphs 4-20 and 4-23) requires investment of the replacement reserve in only selected projects and encourages it in all others, the authors are aware of instances in which REAC is imposing this requirement on entities where it is only encouraged. HUD's strong preference is emphasized in the HUD audit guide's compliance requirement quoted in the previous paragraph. HUD Handbook 4350.1, Paragraph 4-22, allows deposits to exceed the federal insurance limits if the entity monitors and documents whether the financial institution has a rating consistent with minimally acceptable ratings established by GNMA and maintains documentation of the ratings for at least three years.

Withdrawals from the reserve fund for replacements must be approved by HUD. HUD Handbook 4350.1, Paragraph 4-9, presents a list of repair and replacement expenditures for which reserve funds can be used.

Compliance Audit Procedures. Procedures for auditing the entity's compliance with the replacement reserve compliance requirements should be performed.

Residual Receipts

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.E.1., states that the compliance requirement for residual receipts is as follows:

> Nonprofit owners and owners of limited distribution projects, Section 202 projects, and Section 811 projects shall establish a residual receipts account and make deposits into the account in accordance with HUD requirements within 90 days after the close of the fiscal year. Disbursements from such fund may be made only after written consent is received from HUD.

Residual receipts generally consist of the following:

- All "surplus cash" for nonprofit projects.
- Surplus cash in excess of allowable distributions for limited distribution (or limited dividend) entities.
- Collections in excess of a BMIR "contract rent" for Section 221(d)(3) BMIR projects.

If the difference between the monthly operating rent potential and the total tenant payment for *all* units covered by the assistance payment contract is a negative amount, the owner must deposit that amount into the property's residual receipts account on a *monthly* basis.

Housing Notice 2012-14, "Use of 'New Regulation' Section 8 Housing Assistance Payments (HAP) Contracts Residual Receipts to Offset Project-Based Section 8 Housing Assistance Payments" sets new policy for using funds in the residual receipts account to offset payments that would be received under a HAP contract. The housing notice only applies to projects that receive rent subsidies in the Section 8 New Construction and Substantial Rehabilitation Program.

Profit-motivated entities generally are not required to maintain residual receipts accounts since all surplus cash of such projects is available for distribution to the partners (or shareholders). In the case of limited distribution entities, a statutory percentage of surplus cash is distributed to partners (or shareholders), and the remainder is deposited into the residual receipts account. In the case of nonprofit entities, all surplus cash is deposited in the residual receipts account. HUD permits certain Section 202 projects to deposit surplus cash in the reserve fund for replacements rather than a residual receipts account.

HUD allows the funds in the residual receipts account and the reserve fund for replacements to be combined for the purpose of purchasing investments. However, the investment principal and interest earned must be returned to the respective accounts upon liquidation of the investment. Residual receipts are held by the mortgagee, except in the case of Sections 202 and 811 projects.

Instances of noncompliance that auditors commonly encounter when performing tests of the residual receipts compliance requirement include the following:

- Entities failing to establish a residual receipts account.
- Entities failing to fund the residual receipts account within 60 days after a Section 202 entity's fiscal year end.

Compliance Audit Procedures. Procedures for testing the entity's compliance with the residual receipts compliance requirements should be performed. *PPC's Guide to HUD Audits* provides suggestions for compliance audit procedures.

Distributions to Owners

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.F.1., states that the compliance requirement for distributions to owners is as follows:

> Owners may not make, receive, and/or retain any distribution of assets or any income of any kind of the project except surplus cash and then only under certain conditions. Surplus cash distributions can only be made as of and after the end of a semiannual or annual fiscal period. Surplus cash distributions cannot be made when the owner is in default under any of the terms of the regulatory agreement, the note, or mortgage. Surplus cash distributions cannot be made out of borrowed funds or if the owner has not complied with all outstanding notices, from HUD or from the mortgagee, for proper maintenance of the project. The allowable distribution for limited distribution owners is further restricted to a percentage of the owner's initial equity investment as described in the regulatory agreement, business agreement or subsequent HUD-approved agreements with the balance of surplus cash required to be deposited in a residual receipts account.

A HUD-assisted entity can pay distributions only in accordance with the terms of its regulatory agreement. The term *distribution* is defined broadly to include many types of payments. It includes:

a. Distributions of cash and property to partners (or shareholders).

b. Management fees paid to a general partner.

c. Payments of unreasonable amounts to related party management agents for services rendered to the project (for example, building maintenance, landscaping, etc.).

d. Repayments of owner advances that have not been approved by HUD.

As stated in the compliance requirement for distributions to owners, for-profit HUD entities are only allowed to make surplus cash distributions in accordance with the regulatory agreement and in compliance with any other amendments or associated documents. The term *surplus cash* has a specific definition for a HUD entity, and HUD regulations determine how surplus cash is calculated. Unallowable distributions that are not authorized under the regulatory agreement should be reported as questioned costs in the schedule of findings, questioned costs, and recommendations.

Compliance Audit Procedures. *PPC's Guide to HUD Audits* presents suggested procedures for testing the entity's compliance with requirements pertaining to owner distributions.

Equity Skimming

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.G.1., states that the compliance requirement for equity skimming is as follows:

> Equity skimming is the willful misuse of any part of the rent, assets, proceeds, income, or other funds derived from the project covered by the mortgage for any purpose other than to meet actual or necessary expenses of the project. Equity skimming deprives the project of needed funds for repairs, maintenance, and improvements, which contributes to the financial and physical deterioration of the project and the standard of living conditions for the families who depend on the federal government to provide housing. Also, a community where the project is located suffers since the project may become the breeding ground for crime, violence, and drugs. Appendix B to Chapter 3 of the HUD audit guide includes areas disclosed in audit reports in which equity skimming was found in the operations of multifamily projects.

The HUD audit guide states that the suggested audit procedures in Chapter 3 of the HUD audit guide are designed to disclose equity skimming. The HUD audit guide, at Appendix B to Chapter 3, "Information on Equity Skimming," states that equity skimming is considered to be a fraud. The auditor needs to be aware of conditions that might indicate equity skimming and consider modifying his or her audit procedures if such conditions are found. If equity skimming is found, Paragraph 2-5 of the HUD audit guide directs the auditor to follow the Yellow Book requirements, described in Lesson 1, when considering what to report. If the circumstances are such that the Yellow Book requires the auditor to report directly to outside parties, the communication needs to be made to the HUD OIG single audit coordinator.

Appendix B to Chapter 3 of the HUD audit guide provides a discussion of conditions found by HUD in audits of multifamily programs that are categorized as equity skimming. HUD has provided the following examples of equity skimming to help establish an understanding of equity skimming conditions:

a. In reviews of cash disbursements and expense accounts, HUD found HUD-assisted funds were used to pay for:

   (1) Maintenance, administrative, or other expenses of the owner, other programs, or other projects.

   (2) Debts of the owners or management agent.

   (3) Loans to owners, principals, or affiliate companies.

   (4) Mortgages and related expenses not related to the entity.

   (5) Personal expenses, such as food, clothing, entertainment of spouse and friends, private car expenses, etc., on a project credit card.

   (6) Individual partner tax preparation or counseling fees (only the preparation of the entity tax return may be paid from operations).

(7) Legal fees for handling disputes among partners.

(8) Expenses related to arranging the sale of the project or part of the project.

(9) Splitting of fees with the management agent or others who provide services to the project. (This can be an illegal kickback whereby a company agrees to refund a portion of its fees to an owner in return for awarding the management or services contract to the company.)

(10) Theft of funds in which owners or management agents may write checks to themselves or relatives and not try to hide the fact that they have taken the funds.

(11) Expenses to identity-of-interest companies when:

(a) The identity-of-interest company is a conduit for the purchase of materials and supplies and adds on an excessive percentage markup beyond what it needs to cover its own costs.

(b) The identity-of-interest company is paid for labor and materials to repair the project but is using on-site maintenance staff and/or materials to do the work.

(c) The identity-of-interest company is leasing equipment to the project at rates significantly in excess of those charged on the open market.

(d) No work was ever done. The identity-of-interest company may not actually exist, and the bank account may be used to launder funds.

(e) The cost for property and liability insurance for the project is in excess of prices charged on the open market or for coverage that is inadequate to protect HUD's interests.

(f) The identity-of-interest company provides insurance for the property under a blanket policy covering several HUD and non-HUD properties. The owner or management agent may be prorating an excessive amount to the HUD properties and using the excess reimbursement to offset insurance costs for its non-HUD projects or as a means to divert project funds.

b. In reviews of cash receipts and revenue accounts, HUD found:

(1) Rental units were used for owner activities without HUD approval and no rent was collected for the unit.

(2) Income from contracted services such as laundry services, cell tower leases, and cable fees to tenants was retained by the owner.

(3) Units were recorded as vacant but were actually rented. The rent received was split between the owner and the management agent.

Compliance Audit Procedures. Auditors need to be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test all compliance areas.

Cash Receipts

Compliance Requirements. The HUD audit guide, at Paragraph 3-5.H.1., states that the compliance requirement for cash receipts is as follows:

> All cash receipts, including those collected by a management agent, must be deposited into an account in the name of the project at an institution in which deposits are federally insured. The project's owner must verify that depositories where it maintains funds in excess of $100,000 meet certain conditions as outlined in Chapter 2 of HUD Handbook 4370.2.

Cash receipts must be deposited in the name of the HUD-assisted entity in a *federally insured* account. HUD HB 4370.2 REV-1, Paragraph 2-12, allows deposits to exceed the federal insurance limits if the management agent and project owner monitor and document whether the financial institution has a rating consistent with minimally acceptable ratings established by GNMA and maintain documentation of the ratings for at least three years.

Instances of noncompliance that auditors commonly encounter in this area include the failure to deposit funds in a federally insured account. Funds need to be held by financial institutions with deposits that are insured by the Federal Deposit Insurance Corporation, National Credit Union Association, or another federal government insurance corporation. Auditors need to be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test the compliance requirements for cash receipts.

Compliance Audit Procedures. Procedures for testing the entity's compliance with the cash receipts compliance requirement should be performed.

Cash Disbursements

The HUD audit guide, at Paragraph 3-5.I.1., states that the compliance requirement for cash disbursements is as follows:

> All disbursements from the regular operating account must be supported by approved invoices, bills, or other supporting documentation. Project funds should only be used to pay for mortgage payments, required deposits to the reserve for replacement fund, reasonable expenses necessary for the operation and maintenance of the project, distributions of surplus cash as permitted, and repayment of owner advances from surplus cash or as authorized by HUD. Disbursements from a centralized account must clearly be traceable to each entity. The actual cash position of each project in this account must be easily identifiable at all times without exception.

HUD HB 4370.2 REV-1, Paragraph 2-12, states that cash disbursements must be made only in accordance with:

a. The "provisions for project expenses." Essentially, the term "provisions for project expenses" means accounts listed in the HUD chart of accounts, and, for entities that are required to submit budgets to HUD, additional accounts approved by HUD as part of the budget process.

b. Distributions of surplus cash.

Material expenditures not falling into one of those two categories should be reported as questioned costs in the schedule of findings, questioned costs, and recommendations. Additionally, expenditures that fall within HUD's broadly defined concept of "unallowable distributions" should be reported as questioned costs regardless of materiality. Auditors also need to be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test the compliance requirements for cash disbursements.

Instances of noncompliance that auditors commonly encounter in this area include the following:

- Paying unreasonable amounts to related party management agents for services rendered to the project (for example, building maintenance, landscaping, etc.). "Unreasonable amounts" means amounts exceeding the amounts ordinarily paid for such services. Such payments are considered "unallowable distributions" and should be reported in the schedule of findings, questioned costs, and recommendations regardless of materiality.

- Repaying owner advances when the project is in a nonsurplus cash position without first obtaining HUD's approval. Such payments should be reported in the schedule of findings, questioned costs, and recommendations regardless of materiality. Repaying owner advances without obtaining HUD's approval can also subject the project owner to criminal and civil penalties.

Compliance Audit Procedures. Procedures for testing compliance with the cash disbursements compliance requirement are provided in an appendix to *PPC's Guide to HUD Audits*.

Tenant Application, Eligibility, and Recertification

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.J.1., states that the compliance requirement for tenant application, eligibility, and recertification is as follows:

> Owners who participate in HUD's rent subsidy programs are responsible for accepting applications, maintaining a waiting list, determining eligibility, calculating the tenant's contribution toward rent and utilities, calculating subsidy, and recertifying the tenant annually in accordance with HUD requirements.

The entity is responsible for accepting applications from prospective tenants and certifying that the applicants' income levels qualify them for rental assistance. The entity must also recertify incomes of existing tenants at least annually.

The audit guidance quoted above is specifically applicable to HUD-assisted projects subject to HUD Handbook 4350.3 REV-1. Project owners who own market-rate apartments are not subject to the *prescriptive* documentation requirements regarding tenant application, eligibility and recertification.

The primary sources of information on HUD's requirements in the areas of application, eligibility, and recertification are as follows:

- The Housing Assistance Payments (HAP) Contract.
- HUD HB 4350.3 REV-1 CHG-4, "Occupancy Requirements of Subsidized Multifamily Housing Programs."

HUD-assisted project owners are required to use the Enterprise Income Verification (EIV) system to obtain income data for potential and existing tenants. The final rule requiring multifamily owners to use the EIV system was issued after the most current version of Chapter 3 of the HUD audit guide was issued. In the authors' opinion, EIV requirements represent a significant compliance area; accordingly, suggested audit procedures for testing compliance should be performed.

Compliance Audit Procedures. When performing suggested procedures for testing the entity's compliance with the tenant application, eligibility, and recertification compliance requirement, some procedures may be coordinated with compliance tests for other compliance areas because the same sample is used to test more than one compliance area. It is a best practice to incorporate these efficiencies when allowed in the HUD audit guide.

Units Leased to Extremely Low-income Families

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.K.1., states that the compliance requirement for units leased to extremely low-income families is as follows:

> For each project assisted under a contract for project-based Section 8 assistance, the owner must lease not fewer than 40 percent of the dwelling units to extremely low-income families (HUD Handbook 4350.3, Chapter 3, and Chapter 4, paragraph 4-5).

HUD Handbook 4350.3 REV-1 provides extensive coverage of leasing and occupancy requirements for rent subsidized projects. Coverage includes the requirements for certification of tenant income and billing HUD for assistance payments.

Compliance Audit Procedures. Procedures for testing compliance with the requirements for units leased to extremely low-income families should be completed.

Tenant Security Deposits

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.L.1., states that the compliance requirement for tenant security deposits is as follows:

> Funds collected as a security deposit shall be kept in the name of the project, separate and apart from all other funds of the project in a trust account. The amount of this account shall at all times equal or exceed the aggregate of all outstanding obligations under that account. Funds must not be commingled with funds from any other projects. All disbursements from the security deposit account must be only for refunds to tenants and for payment of expenses incurred by or on behalf of the tenant, not to exceed the amount to which the tenant is entitled. All disbursements must have supporting documentation. In addition, state and local governments may have specific regulations governing the handling of tenant security deposits.

HUD does not require that owners charge applicants a security deposit, but most owners usually do so. Owners of Section 8 new construction and Section 8 substantial rehabilitation projects subject to the "revised Section 8 regulations" are required to maintain security deposits in an interest-bearing account and to have the interest earned on the deposit inure to the benefit of the tenant. (A project is subject to the Section 8 revised regulations if it is a new construction or substantial rehabilitation project for which the project owner received their notice of funds reservation on or after November 5, 1979, and February 20, 1980, respectively.)

Generally, applicants can be charged only the security deposit plus the first month's rent. (However, owners of subsidized projects for the elderly may also ask the tenant to pay a pet deposit.) Under no circumstances may the owner charge initial applicants the following types of fees:

- Application processing fees.
- Fees for verifying the applicants' income and eligibility for housing.
- "Home visit" fees, that is, fees that the owner charges applicants for inspecting the applicants' current housing before accepting their applications.

Owners must refund the security deposit no later than 30 days after the tenant moves out. (State or local laws may mandate a quicker refund, however.) The owner is required to send departing tenants a letter that lists amounts offset against the security deposit (for items such as unpaid rent or damages) and advises the tenants of their right to meet with the owner and discuss the charges. If a tenant chooses not to meet with the owner, that fact is documented by the owner. HUD Handbook 4350.3 REV-1, Paragraph 6-18, states that records pertaining to the refund of the departing tenant's security deposit should be retained by the owner for three years.

The security deposit account must be "fully funded," at all times; that is, it needs to have sufficient funds to make refunds to all tenants. It is a violation of the regulatory agreement to underfund the security deposit account.

Compliance Audit Procedures. Procedures for testing the entity's compliance with the security deposits compliance requirement should be performed. One such procedure might involve selecting a representative number of tenants who have moved out during the period to determine whether the owner is refunding security deposits in accordance with HUD's requirements. Because in most cases inherent risk and control risk are low, the compliance test can be performed simultaneously with the tests of controls over cash disbursements and tests of compliance for cash disbursements. However, if inherent risk and control risk are other than low, the auditor selects a sample of tenant files and tests the details of the transaction. (Inherent risk and control risk might be other than low when there are new personnel performing cash disbursement functions or if the auditor had identified errors in this area in prior audits.)

Management Functions

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.M.1., states that the compliance requirement for management functions is as follows:

> The owner is responsible for complying with all requirements of the regulatory agreement. The owner may perform all management functions or contract with a management agent to provide project management, but the responsibility cannot be delegated to the management agent. The owner or management agent must be approved by HUD and must certify that it will follow HUD's rules and regulations.

The specific requirement, "Management Functions," encompasses several HUD requirements that are not addressed in the other specific requirements. Having been extracted from various HUD handbooks, the "Management Functions" requirements in the HUD audit guide are designed to ensure that the management activities of owner and agent are conducted in accordance with HUD laws and regulations.

Instances of noncompliance that auditors commonly encounter in this area include the following:

a. Payments for maintenance and other operating expenses exceed the amounts ordinarily paid for such services.

b. The management agent is reimbursed by the project for expenses that HUD considers to be already included in the management fee (and, thus, are not separately chargeable to the project), including:

- Expenses incurred by the management agent in connection with designing procedures to keep the project in conformity with HUD requirements.
- Salaries and benefits of the management agent's personnel (except personnel performing "frontline duties," as defined in HUD Handbook 4381.5 REV-2, Chapter 2).
- Hiring and supervising personnel.
- Visiting the project.

The above instances of noncompliance should be reported as questioned costs in the schedule of findings questioned costs, and recommendations. Auditors also need to be alert for conditions that may indicate that equity skimming has occurred when performing the procedures to test the compliance requirements for management functions.

The HUD audit guide includes a suggested procedure to determine whether the project is maintained in good repair and condition. If the units are subsidized, the auditor is to determine whether management's procedures ensure that units meet applicable housing quality standards. The authors believe this can be accomplished by inquiring about whether the project owner or management agent conducted any unit or property inspections during the period covered by the financial statements. The auditor determines if violations of "housing quality standards" were identified in the review and determines if the entity took action to correct them. The housing quality standards are intended to ensure that the owner maintains the housing in a decent, safe, and sanitary condition and cover such areas as building access, security, heating and air conditioning, and utilities. If the entity has not taken corrective action, the auditor discloses that fact in the compliance report. It ought to be emphasized this compliance procedure involves determining whether the entity takes corrective action when violations in housing quality standards have been identified; the auditor is not required to make a judgment about whether the project meets those standards.

Compliance Procedures. Procedures for testing the entity's compliance with the management functions compliance requirement are suggested in *PPC's Guide to HUD Audits*.

Unauthorized Change of Ownership/Acquisition of Liabilities

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.N.1., states that the compliance requirement for unauthorized change of ownership/acquisition of liabilities is as follows:

> Owners shall not, without the prior written consent of HUD, convey, assign, transfer, dispose of, or encumber any of the mortgaged property or permit the conveyance, transfer, or encumbrance of such property.

The HUD regulatory agreement restricts for-profit and limited distribution entities from performing or allowing the conveyance, transfer or encumbrance of the mortgaged property or a beneficial interest in the property without proper consent. HUD must preauthorize such actions in writing to be valid.

Compliance Audit Procedures. Procedures for testing the entity's compliance with the change of ownership and the acquisition of liabilities compliance requirement should be performed. Suggested audit procedures are comprised of inquiry, confirmation of debt, and review of other audit documentation. The procedures for this requirement are similar to the procedures for unauthorized loans discussed above.

Unauthorized Loans of Project Funds

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.O.1., states that the compliance requirement for unauthorized loans of project funds is as follows:

> Owners shall not, without the prior written consent of HUD, assign, transfer, dispose of, or encumber any personal property of the project, including rents, or pay out any funds except for reasonable operating expenses and necessary repairs.

Similar to the previous compliance requirement, the HUD regulatory agreement restricts for-profit and limited distribution entities from assigning, transferring, disposing of, or encumbering any personal property of the project, including rents, without proper consent. HUD must preauthorize such actions in writing to be valid. This prohibition excludes disbursements for reasonable operating expenses and necessary repairs paid out of surplus cash.

Compliance Audit Procedures. Procedures for testing the entity's compliance with the unauthorized loans of project funds compliance requirement should be performed.

Excess Income

Compliance Requirement. The HUD audit guide, at Paragraph 3-5.P.1., states that the compliance requirement for excess income is as follows:

> Owners of properties with mortgages insured under Section 236 of the National Housing Act must submit excess income within 10 days of the end of the month in which it was collected.

Under Section 236 of the National Housing Act, limited distribution entities must not retain excess income without the prior authorization from HUD. Excess income only may be used for purposes authorized by HUD. Excess income is reported using Form HUD-93104, "Monthly Report of Excess Income."

Compliance Audit Procedures. Procedures for testing the entity's compliance with the excess income compliance requirement should be completed. Suggested procedures include testing a sample of Forms HUD-93104 and determining that any amounts retained for the project were used for authorized purposes.

Leased Nursing Homes

The HUD audit guide, at Paragraph 3-5.Q.1., states that the compliance requirement for leased nursing homes is as follows:

> Owners may enter into lease agreements to operate the facility, in which case the operator will be required to execute a regulatory agreement (HUD 92466A-ORCF) with HUD before the note is

> endorsed for insurance. The regulatory agreement requires lease payments to be sufficient to pay all mortgage payments including payments to reserves for taxes, insurance, etc., and payments to the reserve for replacements. If at the end of any fiscal year, payments under the lease have not been sufficient to pay for the above items, the owner and operator/lessee, upon request in writing from HUD, shall renegotiate the amounts due under the lease so that the lease payments shall be sufficient to pay for such items. In addition, the operator/lessee shall provide HUD, within 30 days of request, a financial report, in a form satisfactory to HUD, covering the operations of the mortgaged property and of the project.
>
> The regulatory agreement also requires the operator/lessee to not sublease the project and maintain it in good repair. The owner's regulatory agreement requires the owner to make mortgage payments and reserve deposits. These responsibilities cannot be assigned.

HUD-assisted entities that own nursing homes may enter into leases with other entities that then operate the nursing home. The compliance requirements in this area are designed to determine whether the lease payments are sufficient to allow the entity to service the project's mortgage debt, tax and insurance escrows, and reserve for replacements. Other audit procedures test the lessee's compliance with additional terms of the regulatory agreement such as to properly maintain the project and comply with nondiscrimination laws and regulations.

In September 2012, HUD published a final rule titled, *Federal Housing Administration (FHA); Section 232 Healthcare Facility Insurance Program—Strengthening Accountability and Regulatory Revisions Update*, as 77 FR 55150 (2012-09-07). Auditors need to review the rule for matters of audit significance.

Compliance Audit Procedures. Procedures should be performed to test compliance with the leased nursing homes compliance requirements.

Mark-to-Market Program (M2M)

The Mark-to-Market Restructuring program (M2M) allows an entity to address the situation if its Section 8 rent subsidy contract sets rents at a level that exceeds those charged for unregulated and unsubsidized housing of similar quality and location. The program allows HUD to adjust the contract rents and restructure the entity's mortgage debt. The suggested audit procedures for compliance requirements for entities that have participated in the M2M restructuring program, to the extent they are applicable, must be performed in addition to any other audit procedures that are required to be performed for applicable compliance areas. The compliance requirements are organized into four categories that are designed to test compliance with important aspects of the M2M program. As described in Paragraph 3-6 of the HUD audit guide, these compliance areas are as follows:

- *Capital Recovery Payments for M2M Projects.* This compliance area is designed to test compliance with the restructuring agreement's terms and conditions governing capital recovery payments to the owner. (This compliance requirement is not applicable to cooperatives.)
- *Incentive Performance Fee for M2M Projects.* This compliance area is designed to test compliance with the restructuring agreement's terms and conditions governing payment of the incentive performance fee.
- *Distribution of Surplus Cash for M2M Projects.* This compliance area is designed to test compliance with the restructuring agreement's terms and conditions governing surplus cash payments.
- *Special Rules for Cooperatives.* Additional compliance requirements for cooperative entities are designed to test compliance with the restructuring agreement's terms and conditions governing escrow deposits, and deposits to and withdrawals from the residual receipts account.

Project owners participating in the Mark-to-Market Restructuring program may be required to fund a rehabilitation escrow and to expend the funds in the escrow consistent with the terms of the escrow. HUD has determined that some project owners are not in compliance with the provisions for expending these funds, and is prepared to take disciplinary action against such owners. Auditors need to familiarize themselves with the provisions of depository agreement, and test management's assertions that funds have been expended (a) for qualifying items and (b) within the time frames set forth within the depository agreement.

Compliance Audit Procedures. As suggested in *PPC's Guide to HUD Audits*, procedures should be performed to test compliance with the Mark-to-Market Restructuring program compliance requirements.

Section 236 Decoupling Projects

The HUD audit guide, at Paragraph 3-7.1., states that the compliance requirement for Section 236 decoupling projects is as follows:

> As a condition for receiving continued interest reduction payments (IRP) under section 236(e)(2) and section 236(b), the owner agrees to operate the project in accordance with all low-income affordability restrictions for the period identified by the use agreement.

The Section 236 program offers an interest rate subsidy that lowers the entity's mortgage interest rate. In return, the entity must comply with low-income affordability restrictions. Housing Notices H 2000-8, "Guidelines for Continuation of Interest Reduction Payments after Refinancing" and H 2013-25, "Updated Guidelines for Continuation of Interest Reduction Payments after Refinancing: 'Decoupling,' as allowed by the National Housing Act, under Section 236(e)(2)," provide guidance about "decoupling" the interest rate subsidy from the Section 236 loan so the subsidy can continue after the HUD-insured mortgage is refinanced. The suggested audit procedures test compliance with the program's low-income affordability restrictions.

Compliance Audit Procedures. Procedures should be performed to test compliance with HUD's Section 236 decoupling procedures. One method for doing would be to use the suggested procedures found in the practice aids provided in *PPC's Guide to HUD Audits*. Suggested procedures for all of the compliance testing recommended in this section can be found in that guide.

SUMMARIZE AND EVALUATE THE RESULTS OF COMPLIANCE TESTS

In the compliance portion of a HUD audit, the objective of testing the entity's compliance with laws, regulations, and the terms and conditions of federal awards is to provide audit evidence to allow the auditor to express an opinion on whether the entity has complied, in all material respects, with the compliance requirements that *could* have a direct and material effect on each major program. It can be difficult to assess the materiality of instances of noncompliance, because the auditor is not in a position to completely understand some of the implications of instances of noncompliance that might, for example, cause federal officials to eliminate or discontinue federal programs, disallow charges, or demand refunds. However, the HUD audit guide and the Uniform Guidance do not require an opinion that noncompliance *will* have a material effect, but only that noncompliance *may* have a material effect.(It will help the auditor to remember that federal agencies have determined that noncompliance with the requirements listed in the HUD audit guide and the Compliance Supplement could have a material effect.)

Paragraph 10.12 of the GAS/SA Audit Guide provides the following guidance about evaluating noncompliance:

- A material instance of noncompliance is a failure to comply with federal statutes, regulations, and the terms and conditions of the federal award that results in an aggregation of noncompliance that is material to the federal program.
- Instances of noncompliance that may not be individually material should be assessed to determine if, in the aggregate, they could have a material effect. This requires consideration of the type and nature of the noncompliance, as well as the actual and projected effect on each major program in which the noncompliance was identified.
- Noncompliance that is material to one major program may not be material to another major program that is different in size or nature.
- Materiality for a specific major program can change from one audit to the next.

AU-C 935.A31 lists the following factors the auditor might consider in evaluating the effect of identified instances of noncompliance:

a. The frequency of noncompliance with the direct and material compliance requirements identified in the audit.

b. The nature of the noncompliance with the direct and material compliance requirements.

c. The adequacy of the entity's system for monitoring compliance with the direct and material compliance requirements and the possible effect of any noncompliance on the entity.

d. Whether any identified noncompliance with the direct and material compliance requirements resulted in likely questioned costs that are material to the program.

The auditor's evaluation of whether the entity materially complied with the direct and material compliance requirements includes consideration of noncompliance the auditor identified even if the entity corrected it after it was brought to management's attention.

The auditor's considerations of materiality and the calculation of materiality at the major program level should be documented. The auditor's reports on compliance that are typically issued in an HUD audit engagement are discussed in Lesson 3.

If sampling is used in tests of compliance, the auditor compares the number of deviations detected to the number of allowable deviations. The sampling procedure and its results (that is, the number of deviations found, if any, from the compliance requirement), as well as the conclusion about the entity's compliance with the applicable compliance requirement, should be documented, either in a practice aid or in a memo. (Using audit sampling for testing compliance in a HUD audit is discussed in Lesson 3.)

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

13. Which of the following compliance requirements lends itself to being tested using audit sampling?
    a. Cash receipts and disbursements.
    b. Mortgage status.
    c. Distributions made to owners.
    d. Unauthorized loans of project funds.
14. Which of the following is a condition that must exist for the auditor to use group project-based sampling?
    a. The owner(s) can orally agree to using the method.
    b. Tenant security deposits and management functions must be excluded.
    c. All HUD-assisted entities in the group must use the same system for that compliance area.
    d. Tests of internal control must not have disclosed more than one material weakness or two significant deficiencies.
15. Which of the following is an owner-adopted preference for applicants to HUD-assisted projects that may need to be approved in advance by HUD?
    a. Family status.
    b. Residency.
    c. Religion.
    d. Displacement by government action.
16. HUD-assisted entities can charge applicants which of the following?
    a. An application processing fee.
    b. A fee to verify the applicant's eligibility.
    c. A security deposit.
    d. A "home visit" fee.
17. The Mark-to-Market (M2M) restructuring program does which of the following?
    a. Allows HUD to adjust contract rents and restructure mortgage debt if the entity's Section 8 rent subsidy contract sets rents that exceed a certain level.
    b. Offers an interest rate subsidy to lower an entity's mortgage interest rate in return for compliance with low-income affordability restrictions.
    c. Helps tenants provide verification of their annual income to the HUD-assisted entity on at least an annual basis.
    d. Allows for-profit entities to convey, transfer, or encumber mortgaged property to other entities without permission from HUD.

18. Which of the following factors would help with an auditor's evaluation of the effect of identified instances of noncompliance?

    a. The frequency of noncompliance with all compliance requirements identified in the audit.

    b. The nature of noncompliance with direct and material compliance requirements.

    c. The complexity of the entity's system for monitoring compliance with the applicable compliance requirements.

    d. Whether or not any noncompliance was corrected after it was brought to the attention of management.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

13. Which of the following compliance requirements lends itself to being tested using audit sampling? **(Page 175)**

    a. **Cash receipts and disbursements. [This answer is correct. According to Chapter 3 of the HUD audit guide, compliance requirements that lend themselves to testing by audit sampling typically include those that relate to activities or transactions that can be quantified. Examples of such requirements include federal financial reports, replacement reserve, cash receipts, and cash disbursements.]**

    b. Mortgage status. [This answer is incorrect. Per Chapter 3 of the HUD audit guide, mortgage status is typically a nonsampling requirement.]

    c. Distributions made to owners. [This answer is incorrect. Certain compliance requirements, as outlined in the HUD audit guide, typically are not tested using audit sampling. Distributions to owners is one such requirement.]

    d. Unauthorized loans of project funds. [This answer is incorrect. Both unauthorized change of ownerships/acquisition of liabilities and unauthorized loans of project funds are generally considered nonsampling requirements under the HUD audit guide.]

14. Which of the following is a condition that must exist for the auditor to use group project-based sampling? **(Page 178)**

    a. The owner(s) can orally agree to using the method. [This answer is incorrect. According to Paragraph 3-1 of the HUD audit guide, the owner(s) must agree to the group project-based sample method and the owner's *signed* agreement must be included in the auditor's documentation. An oral agreement is not enough.]

    b. Tenant security deposits and management functions must be excluded. [This answer is incorrect. Group project-based sampling may *only* be used for testing the compliance areas of tenant appreciation, eligibility, and recertification; tenant security deposits; and management functions. All other compliance requirements are to be tested separately for each individual HUD-assisted project.]

    c. **All HUD-assisted entities in the group must use the same system for that compliance area. [This answer is correct. The HUD audit guide, at Paragraph 3-1, states four conditions that must exist in order to use group project-based sampling. One of those conditions is that the same system must be used by management for the applicable compliance area for all HUD-assisted entities selected for inclusion in the group project-based sample.]**

    d. Tests of internal control must not have disclosed more than one material weakness or two significant deficiencies. [This answer is incorrect. According to the HUD audit guide, for entities that are to be included in the population and sample for group project-based sampling, the compliance area must have the same supervisor for all projects, the procedures followed must be identical, and the test of internal controls over compliance must not have disclosed *any* internal control weaknesses; for example, significant deficiencies or material weaknesses.]

15. Which of the following is an owner-adopted preference for applicants to HUD-assisted projects that may need to be approved in advance by HUD? **(Page 183)**

    a. Family status. [This answer is incorrect. Preference based on family status is *not* allowed for HUD-assisted projects. The entity is required to select housing applicants in a nondiscriminatory manner, that is, without regard to the applicant's family status, among other things.]

b. **Residency. [This answer is correct. As outlined in HUD Handbook 4350.3 REV-1, Paragraph 4-6, entities may adopt certain additional preferences for housing applicants, some of which may require advance approval by HUD. Examples of such preferences include (1) residency, (2) working family, (3) disability, (4) victims of domestic abuse, and (5) certain single persons groups.]**

c. Religion. [This answer is incorrect. HUD-assisted entities are required to select housing applicants in a nondiscriminatory manner, that is, without regard to the applicant's race, color, religion, sex, disability, family status, or national origin. Certain other preferences, as discussed in HUD Handbook 4350.3 REV-1, Paragraph 4-6, may affect applicant's order on the waitlist, but not their eligibility for the project.]

d. Displacement by government action. [This answer is incorrect. Owners of Section 221(d)(4), 221(d)(3), and 221(d) BMIR properties *must* give preference to applicants who have been displaced by government action or a presidentially declared disaster. Owners of Section 236 properties also *must* give preference to applicants who have been displaced by government action or a presidentially declared disaster. These preferences apply as described in HUD Handbook 4350.3 REV-1, Paragraph 4-6. They are not considered owner-adopted preferences.]

16. HUD-assisted entities can charge applicants which of the following? **(Page 192)**

a. An application processing fee. [This answer is incorrect. Under no circumstances does HUD allow owners allowed to charge initial applicants application processing fees.]

b. A fee to verify the applicant's eligibility. [This answer is incorrect. Owners are not allowed to charge fees for verifying applicants' income and eligibility for housing by HUD.]

c. **A security deposit. [This answer is correct. Generally, applicants can be charged only the security deposit plus the first month's rent. Owners of subsidized projects for the elderly may also ask the tenant to pay a pet deposit. HUD does not require that owners charge applicants a security deposit, but most owners usually do so.]**

d. A "home visit" fee. [This answer is incorrect. There are certain types of fees that HUD does not allow owners to charge under any circumstances. One such fee is "home visit" fees (fees that the owner charges applicants for inspecting the applicants' current housing before accepting their applications).]

17. The Mark-to-Market (M2M) restructuring program does which of the following? **(Page 195)**

a. **Allows HUD to adjust contract rents and restructure mortgage debt if the entity's Section 8 rent subsidy contract sets rents that exceed a certain level. [This answer is correct. The M2M restructuring program allows an entity to address the situation if its Section 8 rent subsidy contract sets rents at a level that exceeds those charged for unregulated and unsubsidized housing of similar quality and location. The program allows HUD to adjust the contract rents and restructure the entity's mortgage debt. The suggested audit procedures for compliance requirements for entities that have participated in the M2M restructuring program, to the extent they are applicable, must be performed in addition to any other audit procedures that are required to be performed for applicable compliance areas.]**

b. Offers an interest rate subsidy to lower an entity's mortgage interest rate in return for compliance with low-income affordability restrictions. [This answer is incorrect. This is the Section 236 program, not the M2M restructuring program.]

c. Helps tenants provide verification of their annual income to the HUD-assisted entity on at least an annual basis. [This answer is incorrect. The entity is responsible for accepting applications from prospective tenants and certifying that the applicants' income levels qualify them for rental assistance. The entity must also recertify incomes of existing tenants at least annually. This is not done using the M2M restructuring program.]

d. Allows for-profit entities to convey, transfer, or encumber mortgaged property to other entities without permission from HUD. [This answer is incorrect. The HUD regulatory agreement restricts for-profit and limited distribution entities from performing or allowing the conveyance, transfer, or encumbrance of mortgaged property or a beneficial interest in the property without proper consent. HUD must preauthorize such actions in writing to be valid, and use of the M2M restructuring program is not involved.]

18. Which of the following factors would help with an auditor's evaluation of the effect of identified instances of noncompliance? **(Page 197)**

a. The frequency of noncompliance with all compliance requirements identified in the audit. [This answer is incorrect. According to AU-C 935.A31, one of the factors that an auditor might consider when evaluating the effect of identified instances of noncompliance is the frequency of noncompliance with the *direct and material* (not all) compliance requirements identified in the audit.]

b. **The nature of noncompliance with direct and material compliance requirements. [This answer is correct. As outlined in AU-C 935.A31, auditors might consider the nature of the noncompliance with the direct and material compliance requirements when evaluating the effect of identified instances of noncompliance.]**

c. The complexity of the entity's system for monitoring compliance with the applicable compliance requirements. [This answer is incorrect. Per AU-C 935.A31, one factor that an auditor may consider when evaluating the effect of identified issues of noncompliance is the *adequacy* of the entity's system for monitoring compliance with the direct and material compliance requirements and the possible effect of any noncompliance on the entity. The complexity of the entity's system is not a consideration.]

d. Whether or not any noncompliance was corrected after it was brought to the attention of management. [This answer is incorrect. The auditor's evaluation of whether the entity materially complied with the direct and material compliance requirements includes consideration of noncompliance the auditor identified even if the entity corrected it after it was brought to management's attention. However, this is not one of the factors listed in AU-C 935.A31, so there is a better answer choice for this question.]

Lesson 3: Reporting and Auditing Considerations

INTRODUCTION

Lesson 3 discusses reporting and auditing issues that may occur in HUD compliance audits. It begins with discussions of reporting on compliance, questioned costs, and fraud or equity skimming. Next, this lesson examines audit sampling in tests of internal control over compliance and tests of compliance with laws and regulations. Finally, Lesson 3 concludes the course with a discussion of special considerations that may apply in audits of nonprofit HUD-assisted entities.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize issues related to compliance reports, such as questioned costs, fraud, and equity skimming.
- Determine how audit sampling may be used in tests of internal control over compliance and tests of compliance with laws and regulations.
- Identify special considerations that may apply when performing a compliance audit for a nonprofit HUD-assisted entity.

REPORTING ON COMPLIANCE IN A HUD AUDIT

AU-C 935.29 requires the auditor to form an opinion and report, at the level specified by the governmental audit requirement, on whether the entity complied in all material respects with the applicable compliance requirements. In a compliance audit of either a for-profit or a nonprofit HUD-assisted entity, the auditor must report on compliance, including an opinion (or disclaimer of opinion) as to whether the auditee complied with laws, regulations, and the provisions of contracts or grant agreements that could have a direct and material effect on each major program. In forming an opinion, the auditor must evaluate (a) known and likely questioned costs and (b) other material noncompliance that, typically, might not have questioned costs.

The auditor considers the impact of known and projected instances of noncompliance at two levels when reporting on compliance—first, at the program level and then, at the financial statement level (that is, for HUD-assisted entities this would be relative to the materiality level set for the financial statements being reported on). Several individual immaterial instances of noncompliance need to be assessed to determine if, in the aggregate, they could have a material effect. Because the auditor is expressing an opinion on each major program and not on the aggregate of all major programs, reaching a conclusion about whether the instances of noncompliance, either individually or in the aggregate, are material to a major program dictates consideration of the types and nature of the noncompliance as well as the actual and projected effect on each major program to which the noncompliance relates. Noncompliance that is material to one program may not be material to another program of a different size or nature.

The auditor relates the number of instances of noncompliance that resulted in known questioned costs to the total population and the number of transactions examined. The auditor is not required to report likely questioned costs; however, the auditor is required to report known questioned costs. A discussion about the different thresholds for reporting questioned costs in audits of for-profit and nonprofit HUD entities appears later in this lesson.

Reports and Other Communications versus Opinions on Compliance-related Matters

The distinction between a report or other communication and an opinion is important in compliance auditing. Stated in general terms, the distinction is that an opinion requires a sufficient scope of work to provide a reasonable basis for the opinion to be expressed, but a report or other communication simply states the findings based on a scope of work done for some other purpose. For example, a financial statement audit in accordance with GAAS requires a written communication of significant deficiencies and material weaknesses in internal control that the auditor becomes aware of during the audit, but does not obligate the auditor to search for internal control deficiencies to communicate.

Usually, the scope of work for this type of communication is not sufficient for expressing an opinion on internal control.

A report usually simply describes the results of compliance tests performed as part of the audit of financial statements. On the other hand, an opinion usually requires expanded testing beyond that which is ordinarily required as part of the audit of financial statements and provides overall assurance on compliance rather than being limited to a statement of findings. The same distinction between a report and an opinion usually is relevant also to requirements related to reporting on internal control.

Auditor's Report on Compliance—Report Required by the Yellow Book

In a HUD audit, the auditor issues a report on compliance prescribed by the Yellow Book. Essentially, the Yellow Book requires a report that describes the scope of the tests and the findings. When there are instances of noncompliance, the material instances of noncompliance should be described.

Auditor's Report on Compliance—Report Required by the HUD Audit Guide or OMB's Uniform Guidance

When reporting on compliance applicable to major programs under the HUD audit guide or the provisions of the Uniform Guidance, the objective is to express an opinion on whether the audited entity has complied, in all material respects, with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a direct and material effect on *each* major program. The material effect, in this case, is measured in relation to each individual major program rather than the financial statements.

For an auditor to express an unmodified opinion on major program compliance, he or she will need to have applied all the audit procedures considered necessary. Any restrictions on the scope of the audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient appropriate audit evidence, or an inadequacy in the accounting records, may require the auditor to qualify or disclaim an opinion. If the auditor qualifies or disclaims an opinion on major program compliance, the reasons should be described in the auditor's report. In addition, the auditor should consider the effects of such instances on his or her ability to express an unmodified opinion on the entity's financial statements. Paragraph 13.24 of the GAS/SA Audit Guide explains that a decision to qualify or disclaim an opinion because of a scope limitation depends on how important the omitted procedures are to the auditor's ability to form an opinion on compliance with each major program's requirements. The auditor's assessment of their importance will be affected by the nature and magnitude of the potential effects of the matters in question and their significance to the program. For example, if client-imposed restrictions significantly limit the scope of the audit, the auditor may have to disclaim an opinion on compliance.

The GAS/SA Audit Guide, at Paragraph 13.22, states that AU-C 935.34 explains that the auditor should modify the auditor's opinion on compliance in accordance with AU-C 705, when the auditor concludes that, based on the audit evidence obtained, material noncompliance with the applicable compliance requirements exists and when the auditor is unable to obtain sufficient appropriate audit evidence to conclude whether material noncompliance with the applicable financial reporting framework exists. When material instances of noncompliance related to a major program are detected in a compliance audit performed under the Uniform Guidance, the auditor should express a qualified or adverse opinion on compliance in the report on compliance with requirements that could have a direct and material effect on each major program and on internal control over compliance. The report should include the auditor's basis for such an opinion.

REPORTING QUESTIONED COSTS IN A HUD AUDIT

Noncompliance with a compliance requirement governing federal award programs may result in charges to the program being disallowed. HUD determines whether, in fact, a cost is disallowed. In the compliance audit the auditor, based on the results of the tests of compliance, only questions that the cost charged to a HUD program may not be in compliance with the appropriate requirements set forth in laws, regulations, contracts, and grant agreements. Upon determining that a questioned cost is disallowed, HUD may choose to not reimburse the recipient for the cost or require that funds already expended be refunded.

For-profit Audits

The HUD audit guide, at Paragraph 2-4(C), states that all significant deficiencies, material weaknesses, and material instances of noncompliance identified by the auditor are required to be identified in the body of the report on compliance and internal control over compliance and detailed in a separate schedule of findings, questioned costs, and recommendations. According to AU-C 935.11, *questioned costs* are those that are questioned by the auditor for any of the following reasons:

- They violate (or may violate) applicable compliance requirements.
- They are not supported by adequate documentation.
- They appear unreasonable and do not reflect what a prudent person would do in the circumstances.

In describing the content of the element "questioned costs" that is to be included in each audit finding, the HUD audit guide, at paragraph 2-4(C) states:

> Each finding must identify known questioned costs of items resulting from errors or noncompliance that are quantifiable. Identification of these costs should not be limited to only those costs that potentially are to be repaid. If costs are not quantifiable or are unknown, the auditor should so state and indicate the reasons for that determination.

Examples of expenses that would usually be considered to be questioned costs if charged to a HUD program include the following:

- Unsupported transactions, for example, cancelled checks for which supporting vendors' invoices cannot be located.
- Unallowable distributions to partners (or dividends to shareholders).
- Transactions with affiliated companies that are not reasonable in amount and necessary.
- Expenses incurred by the management agent on behalf of the project for expenses HUD considers to be already included in the management fee (and, thus, are not separately chargeable to the project), including the following:
    - Salaries and benefits of management agent's personnel (except personnel performing "frontline duties," as defined in HUD Handbook 4381.5 REV-2, *Management Agent Handbook*, Chapter 2).
    - Recruiting, hiring, and supervising personnel.
    - Visiting the project.
    - Analyzing and solving project problems.
    - Overseeing investment of project funds.
- Repayments of owner advances without HUD authorization.
- Expenditures for repairing and replacing the building made without prior approval from HUD.

The foregoing items are only examples. The auditor needs to consult the relevant specific compliance requirements when assessing potential audit findings.

Nonprofit Audits

The Uniform Guidance, at 2 CFR section 200.516(a), states that the auditor must report all known questioned costs that are greater than $25,000 for a type of compliance requirement for a major program, known questioned costs when likely questioned costs are greater than $25,000 for a type of compliance requirement for a major program, and known questioned costs that are greater than $25,000 for a federal program that is not audited as a major program. 2 CFR section 200.1 defines a questioned cost as a cost that is questioned by the auditor because of an audit finding:

- Which resulted from a violation or possible violation of a provision of a statute, regulation, or the terms and conditions of a federal award, including funds used to match federal funds.
- Where the costs, at the time of the audit, are not supported by adequate documentation.
- Where the costs incurred appear unreasonable and do not reflect the actions a prudent person would take in the circumstances.

2 CFR section 200.1 further states that questioned costs are not an improper payment until reviewed and confirmed to be improper. Improper payments are discussed below.

The auditor should always consult the relevant audit requirements when testing for compliance. However, some examples of expenses that would usually be considered questioned costs if charged to a federal program include the following:

- Unsupported transactions; e.g., canceled checks (or images thereof) for which supporting vendors' invoices cannot be located.
- Lobbying expenses.
- Entertainment expenses.
- Fund-raising expenses.
- Contributions and donations.
- Any expenses that exceed the funding agency's budget flexibility guidelines.

The auditor may find it helpful to refer to "List of Selected Items of Cost," in Part 3 of the Compliance Supplement for examples of both allowable and unallowable costs.

Part 3 of the Compliance Supplement also provides specific guidance regarding improper payments. It states that federal agencies are required to take actions to prevent improper payments, review awards for such payments, and recover the payments. An improper payment may be:

a. Any payment that should not have been made or that was made in an incorrect amount under statutory, contractual, administrative, or other legally applicable requirements, such as an overpayment or underpayment made to an eligible recipient (resulting from inappropriate denial of payment or service, a payment that does not account for applicable discounts, a payment for an incorrect amount, and a duplicate payment).

b. Any payment made to an ineligible recipient or for an ineligible good or service, or for goods or services not received (except where authorized by statute).

c. Any payment for which documentation is so insufficient that an agency is unable to determine its propriety.

Part 3 of the Compliance Supplement states that auditors must be alert to improper payments, especially when testing Activities Allowed or Unallowed, Allowable Costs/Cost Principles, Eligibility, and, in some cases, Special Tests and Provisions.

Effect of Questioned Costs on the Major Program Compliance Opinion

In evaluating the effect of questioned costs for purposes of forming an opinion on compliance, the auditor considers the best estimate of likely questioned costs (the total costs questioned for each major program) not just the questioned costs specifically identified (known questioned costs). Likely questioned costs are developed by extrapolating from audit evidence obtained; for example, by projecting known questioned costs identified in an audit sample to the entire population from which the sample was drawn. AU-C 935.29 requires the auditor to also evaluate other material noncompliance that, by its nature, might not result in questioned costs. For example, noncompliance with a reporting requirement typically would not result in questioned costs. In situations where known questioned costs are not considered to be material but the likely questioned costs are, the auditor should consider the noncompliance to be material and report an audit finding. Alternatively, the auditor could expand the scope of the audit and apply additional audit procedures to further establish the amount of likely questioned costs.

The GAS/SA Audit Guide, at Paragraph 11.118 explains that because the auditor is required to estimate likely questioned costs associated with an audit finding, it may be necessary to project sample results when determining the effect on the auditor's opinion on compliance and whether an audit finding has to be reported. Projecting sample results is discussed later in this lesson.

A compliance exception indicates a potential deficiency in internal control over compliance. Thus, the auditor relates exceptions from compliance testing to the results from the internal control testing when forming a conclusion about compliance and internal control over compliance.

Paragraph 3-8 of the HUD audit guide requires that nonmaterial instances of noncompliance be reported to management in writing, either in a management letter or some other written correspondence. The form and date of that communication must be included in the auditor's report on compliance.

Other Considerations. The auditor also needs to consider the applicable reporting requirements if noncompliance is identified when group project-based sampling has been used. These reporting requirements were discussed in Lesson 2.

Effect of Questioned Costs on the Financial Statements

Because a questioned cost may not be reimbursed or may have to be refunded, noncompliance with compliance requirements may have a material effect on the financial statements. The auditor has to consider the effect of questioned costs on the financial statements; that is, the need for the entity to record a liability or disclose a contingent liability for questioned costs. The materiality of the uncertainty would be assessed in relation to the financial statements.

As discussed in Paragraph 6.50 of the GAS/SA Audit Guide, there is a lower materiality level for reporting findings in the schedule of audit findings (audit finding materiality) that should not be confused with materiality levels used for planning and performing the HUD audit; expressing an opinion on the entity's compliance with requirements having a direct and material effect on each major program; and planning, performing, evaluating the results of, and reporting on the financial statement audit. Materiality for the compliance opinion is at the major program level, whereas materiality for financial statement adjustment, disclosure, or report modification is at the financial statement level. Thus, an instance of noncompliance or a questioned cost will not automatically be material to the financial statements.

REPORTING FRAUD OR EQUITY SKIMMING IN A HUD AUDIT

The HUD audit guide puts particular emphasis on the auditor's responsibilities if he or she becomes aware of fraud or equity skimming that has occurred or is likely to have occurred. Paragraph 2-5 of the HUD audit guide states:

> . . . fraud could include equity skimming, which is the willful misuse of any part of the rent, assets, proceeds, income, or other funds derived from the project covered by the mortgage, business agreement, regulatory agreement, or other type of agreement for any purpose other than to meet actual or necessary expenses of the project.

The HUD audit guide provides additional information about equity skimming in Appendix B to Chapter 3 of that guide.

The HUD audit guide directs the auditor to follow the Yellow Book requirements that address the auditor's communication responsibilities with regard to fraud or possible fraud. Paragraph 6.41 of the Yellow Book requires the auditor to include findings of fraud that has occurred or is likely to have occurred in the Yellow Book report on internal control over financial reporting and on compliance and other matters. The Yellow Books requires the auditor to provide written communication about findings of noncompliance or abuse "that are less than material but warrant the attention of those charged with governance" to the entity's management. The Yellow Book requirements were discussed in more detail in Lesson 1.

Paragraph 2-5 of the HUD audit guide concludes the discussion about reporting fraud or equity skimming by encouraging auditors to initially communicate with the HUD OIG single audit coordinator about such matters. Such communication can facilitate appropriate decisions about the information that needs to be included in the audit reporting package, the report format, the documentation that may need to be transmitted to the HUD OIG single audit coordinator outside the report, and the distribution of the report.

Exhibit 3-1 is a summary of criminal and civil penalties for violations of HUD laws and regulations. The exhibit is adopted from Appendix 1 of HUD Handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, and OIG Program Fraud Alert: *Fraud and Abuse in Multifamily Mortgage Insurance Programs*.

Exhibit 3-1

Criminal and Civil Penalties

CRIMINAL PENALTIES

Section 1715z-19, Title 12, U.S.C., "Equity Skimming Penalty"

Provides, among other things, that whoever willfully uses or authorizes the use of any part of the rents, assets, proceeds, income, or other funds derived from the property during a period when the mortgage note is in default or the project is in a nonsurplus cash position, for any purpose other than to meet actual or necessary expenses, shall be fined not more than $500,000 or imprisoned not more than 5 years, or both.

Section 1001, Title 18, U.S.C., "Fraud and False Statements"

Provides that whoever knowingly and willingly makes or uses a document or writing containing any false, fictitious, or fraudulent statement about any matter within the jurisdiction of any department or agency of the United States, shall be fined not more than $10,000 or imprisoned for not more than five years, or both.

Section 1010, Title 18, U.S.C., "H.U.D. Transactions"

Makes it a criminal offense to make a willful false statement or misrepresentation to any federal Department or Agency about any matter within its jurisdiction. Violators shall be fined not more than $5,000 or imprisoned not more than two years, or both.

Section 1012, Title 18, U.S.C., "Department of Housing and Urban Development Transactions"

Provides that whoever, with intent to defraud, makes false entry in any book of the Department of Housing and Urban Development, makes any false report or statement to or for HUD, or receives compensation . . . with intent to defraud HUD or with intent to unlawfully defeat its purposes shall be fined not more than $1,000 or imprisoned not more than one year, or both.

CIVIL PENALTIES

Sections 1715z-4a, Title 12, U.S.C., "Double Damages Remedy for Unauthorized Use of Multifamily Housing Projects Assets and Income"

Provides for a double damages civil remedy for the use of assets or income in violation of a regulatory agreement and applicable HUD regulations.

Section 1735f-15, Title 12, U.S.C., "Civil Money Penalties Against Multifamily Mortgagors"

Provides civil money penalties and criminal penalties for project owners who have not honored their commitment with HUD to contribute nonproject (i.e., personal) funds to the project. (Such contributions may be required as a condition to receiving flexible subsidy loans, modifications of mortgage terms, or workout agreements.)

SOURCE: *Financial Operations and Accounting Procedures for Insured Multifamily Projects* (HUD Handbook 4370.2, Appendix 1) and OIG Program Fraud Alert: *Fraud and Abuse in Multifamily Mortgage Insurance Programs*.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

19. Which of the following statements best describes the report on compliance required by the HUD audit guide or the OMB's Uniform Guidance?

    a. The material effect of noncompliance is measured against the financial statements as a whole.

    b. Specific procedures listed in the authoritative guidance must be performed before an unmodified opinion can be issued.

    c. The auditor may have to disclaim or qualify his or her opinion if a scope restriction affects the auditor's work.

    d. When material instances of noncompliance are detected, it may be possible to issue an unmodified report under certain circumstances.

20. Kyle is engaged to audit a nonprofit HUD-assisted entity. Which of the following would he need to consider questioned costs if charged to one of his client's federal programs?

    a. A check matched with a vendor's invoice.

    b. Funds used for lobbying.

    c. Expenses within the funding agency's budget guidelines.

    d. Unallowable distributions made to partners.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

19. Which of the following statements best describes the report on compliance required by the HUD audit guide or the OMB's Uniform Guidance? **(Page 206)**

    a. The material effect of noncompliance is measured against the financial statements as a whole. [This answer is incorrect. When reporting on compliance applicable to major programs under the HUD audit guide or the provisions of the Uniform Guidance, the objective is to express an opinion on whether the audited entity has complied, in all material respects, with laws, regulations, and the provisions of contracts or grant agreements, noncompliance with which could have a direct and material effect on *each* major program. The material effect, in this case, is measured in relation to each individual major program rather than the financial statements.]

    b. Specific procedures listed in the authoritative guidance must be performed before an unmodified opinion can be issued. [This answer is incorrect. For an auditor to express an unmodified opinion on major program compliance, he or she will need to have applied all the audit procedures considered necessary. An exhaustive list is not provided in the authoritative guidance but will vary depending on the facts and circumstances of the HUD audit engagement.]

    c. **The auditor may have to disclaim or qualify his or her opinion if a scope restriction affects the auditor's work. [This answer is correct. Any restrictions on the scope of the audit, whether imposed by the client or by circumstances such as the timing of the auditor's work, the inability to obtain sufficient appropriate audit evidence, or an inadequacy in the accounting records, may require the auditor to qualify or disclaim an opinion. If the auditor qualifies or disclaims an opinion on major program compliance, the reasons should be described in the auditor's report.]**

    d. When material instances of noncompliance are detected, it may be possible to issue an unmodified report under certain circumstances. [This answer is incorrect. When material instances of noncompliance related to a major program are detected in a compliance audit performed under the Uniform Guidance, the auditor should express a qualified or adverse opinion on compliance in the report on compliance with requirements that could have a direct and material effect on each major program and on internal control over compliance. An unmodified report would be inappropriate.]

20. Kyle is engaged to audit a nonprofit HUD-assisted entity. Which of the following would he need to consider questioned costs if charged to one of his client's federal programs? **(Page 208)**

    a. A check matched with a vendor's invoice. [This answer is incorrect. Kyle should consider unsupported transactions questioned costs in this type of audit; e.g., canceled checks (or images thereof) for which supporting vendors' invoices *cannot* be located.]

    b. **Funds used for lobbying. [This answer is correct. Examples of expenses that would usually be considered questioned costs if charged to a federal program include lobbying expenses, entertainment expenses, fund-raising expenses, and contributions and donations. Therefore, Kyle would generally need to consider these funds questioned costs in his nonprofit HUD compliance audit.]**

    c. Expenses within the funding agency's budget guidelines. [This answer is incorrect. Any expenses that *exceed* the funding agency's budget flexibility guidelines would be considered questioned costs. However, as these funds fall within those guidelines, Kyle would not need to question them.]

    d. Unallowable distributions made to partners. [This answer is incorrect. Unallowable distributions to partners are typically questioned costs in the compliance audit of a for-profit HUD-assisted project. Since Kyle is auditing a nonprofit project, there is a better answer to this question.]

USING AUDIT SAMPLING IN TESTS OF INTERNAL CONTROL OVER COMPLIANCE

Although not required for tests of controls, sampling may be used and can be very efficient. However, sampling in a compliance audit differs from sampling in a financial statement audit. Chapter 11 of the GAS/SA Audit Guide provides extensive guidance on sampling in a compliance audit performed in accordance with the Uniform Guidance. While the guidance on sampling in Chapter 11 of the GAS/SA Audit Guide is directly applicable only to Single Audits of nonprofit HUD entities, the authors believe some of the guidance on sampling in tests of compliance controls is useful in audits of for-profit HUD entities. The GAS/SA Audit Guide establishes different sampling terminology and methodology than used in the financial statement audit environment.

Objective of the Tests

The primary objective of tests of controls in a HUD audit is to determine whether the entity has internal control systems in place to provide reasonable assurance that it is managing HUD programs in compliance with applicable laws and regulations. To accomplish that, the auditor performs procedures to obtain an understanding of internal control over compliance sufficient to plan the audit. Then, the auditor must test the effectiveness of the design and operation of the controls in preventing or detecting material noncompliance. The process of testing controls and assessing control risk provides audit evidence about the risk that material noncompliance exists in a HUD program and may permit the auditor to reduce substantive tests of compliance.

Purpose of the Tests

The purpose of tests of controls is to evaluate the effectiveness of the design and operation of controls applicable to each major program that the auditor considers relevant to preventing, or detecting and correcting material noncompliance with compliance requirements subject to audit that are direct and material. Auditors are generally required to perform such tests regardless of whether they would otherwise choose to obtain evidence to support an assessment of control risk below the maximum. However, tests of internal control over compliance are not required for those areas for which controls are likely to be ineffective. Paragraph 1-3(B) of the HUD audit guide and the Uniform Guidance both make it clear, however, that in such a case the internal control report should include the internal control deficiency related to the control(s) not tested.

Identify Significant Controls

The first step in planning the sample is to identify the controls to be tested and, if applicable, the related substantive compliance procedures to be reduced. This step requires identifying controls relevant to specific assertions that are likely to prevent, or detect and correct, material noncompliance in those assertions. All controls that the auditor determines are to be tested to mitigate the risk of material noncompliance are significant controls, but there is a spectrum of significance. The potential magnitude of noncompliance (both qualitatively and quantitatively) if the control were to fail is an important consideration in determining the significance.

Audit sampling can be used in selecting items to test when performing tests of controls over compliance with laws and regulations similar to the way that audit sampling is used in selecting items to test when performing tests of other types of controls. In practice, the most common test of controls that uses audit sampling is a test of transactions. However, not all tests of controls involve the use of audit sampling. Generally, audit sampling is only used for tests of controls for which there is documentation of the operation of the controls. Normally, those tests of controls involve inspection of documents and reports indicating performance of the policy and procedure and, in many cases, reperformance of the application of the control. The approach is usually to sample the documents, inspect items selected for evidence of performance of the control, and reperform the control to test its effectiveness.

Consider Whether Testing Controls Is Practical. As discussed above, auditors are generally required to test controls unless such controls are likely to be ineffective. Thus, testing of controls may not be omitted for audit cost effectiveness reasons simply because it will not restrict substantive tests. When sampling is used in tests of controls, the auditor also considers whether there is documented evidence of the application of the identified controls. Without documented evidence, it may be difficult to test those controls using audit sampling.

Define the Population, Sampling Unit, and Deviation

For a test of controls using audit sampling, the auditor may define the population in one of two ways. Since a particular control often applies to the items of more than one program, the auditor may (a) define the items from each program as a separate population or (b) define all items to which the control applies as a single population. The size of the population has little or no effect on sample size; therefore, it usually will be more efficient to select one sample from all the items to which the control applies.

The sample units in those circumstances are individual transactions of a particular type, and the auditor needs to specify the physical sample unit that will be selected, for example, canceled checks when the population is cash disbursements. Also, the auditor needs to specify the conditions that will be regarded as deviations from prescribed controls.

In audits where project owners and management agents manage more than one HUD-assisted project, the auditor needs to be aware that the audit is performed with respect to a single HUD-assisted entity and not the activities of the project owner or the management agent. Samples should include items from all relevant activities at each HUD-assisted entity.

Determine the Tolerable Deviation Rate and Allowable Risk of Overreliance

The tolerable deviation rate is the maximum rate of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk of noncompliance. Determining the appropriate tolerable deviation rate is strictly an audit decision. The use of sampling forces the auditor to specify in advance what rate of deviation would correspond to the levels of control risk (e.g., high, moderate, or low). Paragraph 11.67 of the GAS/SA Audit Guide explains that to plan for low control risk (i.e., a high level of assurance), an auditor often uses a risk of overreliance of 10% or less with a tolerable deviation rate of 10% or less. There is an inverse relationship between the significance of a control and the auditor's tolerable deviation rate—as the significance of a control increases, the tolerable deviation rate decreases.

The allowable risk of overreliance is similar to the risk of incorrect acceptance in a substantive sample. This means that it—

a. is an aspect of *sampling risk*, and

b. has a corresponding opposite risk (the risk of assessing control risk too high), which does not have to be considered under authoritative pronouncements because it relates solely to efficiency.

Determine the Expected Rate of Deviations

The auditor also considers the expected rate of deviation from a particular control. The authors believe that if the expected rate is over one-half the tolerable rate, sampling is not efficient. However, if the expected rate is high, the auditor would not plan to assess control risk below the high level. In practice, auditors performing tests of controls using sampling assume a zero expected rate. This is analogous to the statistical method of discovery sampling, and it is highly efficient. The established tolerable rate, allowable risk of assessing control risk too low (risk of overreliance), and expected rate are the only factors that need to be specified for determining sample size in a statistical sample size table. For example, Table A-2 in the AICPA Sampling Guide gives sample sizes for a 10% risk of overreliance.

Determine the Sample Size

The size of the sample for a test of controls over compliance depends on the significance of the control being tested and the inherent risk of the compliance requirement. If the auditor plans the audit to support a low level of assessed control risk, the auditor must also plan to obtain a high level of assurance that controls operate as designed.

Appendix A to Chapter 1 of the HUD audit guide provides the sample size tables that should be used when sampling in tests of internal control over compliance are used in audits of for-profit HUD-assisted entities. These tables and the guidance in the HUD audit guide are discussed in more detail later in this lesson. The sample size tables specified in the HUD audit guide do not replace the auditor's judgment; qualitative factors should also be considered when determining sample sizes.

In Single Audits of nonprofit HUD entities, the auditor may use the guidance in Paragraph 11.59 of the GAS/SA Audit Guide for determining the sample size. The suggested sample sizes are designed to provide a high level of assurance. Auditors that perform Single Audits of HUD-assisted entities will find extensive discussion about sampling in audits performed in accordance with OMB's Uniform Guidance in *PPC's Guide to Single Audits*.

Significance of Control. Paragraph 11.61 of the GAS/SA Audit Guide states all controls the auditor decides to test to mitigate the risk of material noncompliance are significant controls, but a spectrum exists concerning the significance of each control. Because minimum sample sizes vary based on the desired confidence levels and tolerable deviation rates, the auditor uses his or her risk assessment to assist in determining which controls are very significant or moderately significant. The higher and more pervasive the risk relating to a given control objective (i.e., the "what could go wrong" risk), the greater the need for assurance on relevant preventive and detective controls to achieve a specific control objective, and the more likely it is that the auditor will assess greater significance for the related controls.

The auditor might consider the potential magnitude of noncompliance (both qualitatively and quantitatively) to the program if the control were to fail when determining the significance level of a control. Also, a control might only be considered moderately significant if there are complementary, compensating, or redundant controls. The auditor should obtain evidence regarding the effectiveness of such controls if the planned level of testing assumes reliance on them. Although this would result in multiple controls being tested for operating effectiveness, each control could be tested as a moderately significant control.

Inherent Risk of Noncompliance. According to AU-C 935.11, *inherent risk of noncompliance* is a compliance requirement's susceptibility to noncompliance that could be material (individually or when combined with other instances of noncompliance) without consideration of related internal controls. Paragraph 11.65 of the GAS/SA Audit Guide provides the following factors that might indicate a federal program has higher inherent risk of noncompliance:

- The program is new.
- The program is in the first or last years of its life cycle at the entity.
- The program is a new program for the federal agency and it is operated under new or interim regulations.
- The program is complex.
- The program involves judgment or complex processing (for example, nonroutine versus routine, nonsystematic versus systematic, manual versus programmed).
- The extent the entity contracts with third parties for goods and services that relate to compliance with program requirements.
- Material weaknesses or significant deficiencies in internal control over compliance were identified in the past.
- Correspondence from program officials indicates potential problems.
- The entity did not adhere to applicable laws and regulations or the terms and conditions of the federal award program in prior years.
- The entity experienced high employee turnover in a particular area.
- The program has a very high volume of activity.
- There has been a substantial change in the policies, processes, or personnel associated with the compliance requirement.
- There have been significant changes in the terms and conditions of the award program or in federal statutes or regulations.

- HUD or the OMB has identified the program as higher risk.

The presence of one or more of the factors may result in the auditor determining that there is higher inherent risk of noncompliance. However, the auditor would use professional judgment to determine whether the number and combination of factors pose higher or limited inherent risk of material noncompliance. The size of the program does not necessarily affect the potential for noncompliance.

Determine the Sample Selection Method and Select the Sample

The auditor should select items for the sample in such a way that he or she can reasonably expect the sample to be representative of the relevant population and likely to provide a reasonable basis for conclusion about the population. It cannot be over emphasized that block sampling (i.e., selecting all the transactions of a particular type for a day, week, or month) is not acceptable.

A distinctive aspect of selecting a sample for a test of controls is that if documents necessary to perform the test are missing, the item normally should be counted as a deviation. AU-C 530.11 requires items to be treated as deviations (tests of controls) or misstatements (tests of details) if the auditor cannot apply designed audit procedures or suitable alternative procedures. This means that when a selected item is missing, the item should be treated as a deviation from the prescribed policy or procedure unless suitable alternative procedures can be performed. For example, if the auditor is testing for supervisory review and approval of invoices by inspecting selected invoices, and an invoice selected cannot be located, there is no documentary evidence the invoice was properly reviewed and approved, and it should be treated as a deviation. In the case of tests of controls, suitable alternative procedures generally are not available. However, unused and legitimately voided documents do not have to be considered as deviations.

Another sampling consideration is whether the sample that was selected includes all of the attributes to be tested. If the sample does not contain any items that include an attribute being tested, the sampling population might not have been defined properly. In this situation, the auditor might consider keeping the original sample and adding other items that include the attribute which was originally excluded, or drawing a new sample. The number of additional items to be considered is a matter of professional judgment.

The auditor needs to be sure that all of the significant controls relating to each compliance requirement subject to audit that is direct and material for each major program are tested. The GAS/SA Audit Guide, Paragraph 11.42 states that when internal control for a type of compliance requirement is common to more than one program, the transactions of those programs may be combined into a single population for purposes of determining sample size and selecting the sample for tests of controls. If the sample that is selected does not include items from each major program, the auditor generally would judgmentally add additional items from any programs from which items were not selected.

Evaluating Sampling Results

The GAS/SA Audit Guide, Paragraph 11.110, states that when evaluating sample results, the auditor would consider sampling risk, i.e., the risk that the auditor's conclusions based on a sample may be different from the conclusions if the entire population had been subjected to the same audit procedure. The auditor cannot simply compare the projected rate of deviation to the tolerable deviation rate and assess controls as effective if the projected rate is lower. The auditor should consider whether the same result would be obtained if the true deviation rate in the population is higher than the tolerable rate of deviation for the population.

Sampling risk may not be directly measurable in a nonstatistical sampling application; however, it is generally appropriate to conclude that the sample results do not support the planned assessed level of control risk of noncompliance if the rate of deviation in the sample exceeds the expected population deviation rate used in designing the sample.

As noted previously, in situations where auditors cannot support a low assessed level of control risk of noncompliance for a compliance requirement subject to audit that is direct and material for a major program, for example, because of deviations in internal controls, they are not required to expand their testing of internal control over compliance for that compliance requirement. Instead, they may choose not to perform additional tests of controls. In that situation, the auditor generally would assess control risk of noncompliance at other than low, design tests of compliance accordingly, and consider the need to report an audit finding. If auditors decide to expand their testing of internal control over compliance, their decision would be based on whether they consider the additional internal control testing to be more efficient than performing additional tests of compliance. Additional considerations for evaluating the results of testing controls over compliance were discussed in Lesson 2.

Calculating the Deviation Rate. Calculating the deviation rate involves dividing the number of observed deviations by the sample size. For example, if 3 deviations are detected in a sample of 60, the deviation rate is 5% (3/60). The sample deviation rate is also the auditor's estimated population deviation rate. If the estimated deviation rate is less than the tolerable rate, the auditor should consider the risk that might result if the true deviation rate in the population exceeds the tolerable rate. For example, if the tolerable deviation rate for a population is 5% and two or more deviations are found in a sample of 60 for a large population, the auditor might conclude that there is an unacceptably high sampling risk that the true rate of deviations in the population exceeds the tolerable rate.

The auditor should investigate the nature and cause of the deviations, such as whether they are due to noncompliance with laws, regulations, or compliance requirements or due to error or fraud, and evaluate the possible effect on the purpose of the audit procedure and on other aspects of the audit. After considering the number of deviations and the reasons for them, the auditor might decide to either expand the test or to perform other tests that include sufficient additional items to reduce control risk to an acceptable level. Instead of expanding the scope of testing, it is often more efficient in a HUD audit to report a deficiency in internal control over compliance, increase the assessed level of risk of material noncompliance, and increase the extent of compliance testing to reflect the change in the control risk of noncompliance assessment.

The GAS/SA Audit Guide, Paragraph 11.103 explains that the sample is expected to be representative only with respect to the rate of deviations, not their nature or cause. An unexpected deviation may be indicative of other deviations in the population. If the auditor selects a small sample because the deviation rate is expected to be small or zero, but finds a deviation rate slightly higher than expected, it may be appropriate to extend the sample if the auditor believes that the observed deviation rate does not represent a reportable finding. However, according to the GAS/SA Audit Guide, the appropriate extension would not be a small one.

The nature and cause of a deviation might indicate that the deviation rate in the sample is not likely to be representative of the population (that is, it is not a systematic error). The auditor might consider performing additional procedures to determine whether the error is isolated to a specific subpopulation. To conclude that a deviation is nonsystemic generally requires the auditor to perform additional audit procedures to obtain sufficient appropriate audit evidence that the actual deviation rate of the sample is not representative of the population deviation rate.

Assessing Control Risk of Noncompliance. Essentially, assessing control risk of noncompliance involves applying the evaluation of the test to the assertions they were matched with when planning the sample. AU-C 330.17 indicates that the auditor should determine whether the audit evidence obtained from the test of controls:

- provides an appropriate basis for reliance on the controls tested,
- indicates that additional tests of controls are necessary, or
- indicates the auditor needs to address the potential risks of material misstatement through substantive procedures.

For controls that are determined to be effective, control risk for the related assertions is assessed as moderate or low, depending on the sufficiency and appropriateness of the evidence obtained. Control risk is assessed as high for remaining assertions because either (a) no related tests of controls were performed or (b) the related controls were tested and determined to be ineffective.

Documenting Samples for Tests of Controls

When using audit sampling for tests of controls, the auditor should consider the professional requirements for audit documentation. AU-C 230, *Audit Documentation*, indicates that auditors performing tests of operating effectiveness of controls involving inspection of documents should include in the workpapers identifying characteristics of the items tested. Documentation of sampling in an audit of compliance is influenced by several factors, including the size and complexity of the entity, the nature and complexity of the compliance requirements and of internal control over compliance, and the entity's past experience relative to compliance. The GAS/SA Audit Guide, Paragraph 11.135 provides the examples of items the auditor typically documents for sampling in an audit of compliance. Those examples in an audit of a HUD-assisted entity would include:

- A description of the control or compliance requirement being tested.
- A definition of the population and the sampling unit, including how completeness of the population was determined.
- A definition of a deviation or exception condition.
- The desired confidence or assurance level, tolerable deviation or exception rate, and expected population deviation or exception rate.
- The sample size.
- The sample selection method (e.g., random, haphazard, or systematic selection).
- The selected sample items, including identifying characteristics of the specific items tested and resolution of missing documents.
- An evaluation of the sample, including:
    - The number of deviations or exceptions noted.
    - Important qualitative aspects of the deviation(s) or exception(s).
    - The projected population deviation or exception rate.
    - A determination of whether the sample results support the test objective.
    - The effect of the evaluation on other audit procedures (for example, if tests of controls do not allow the auditor to support a low assessed level of control risk of noncompliance for HUD-assisted programs, consideration of the effect on tests of compliance).
    - The auditor's determination of known questioned costs and estimation of likely questioned costs.
    - The auditor's determination of whether observed deviation(s) or exception(s) require the auditor to modify the opinion (or report) on compliance or report a finding and, if not, how the auditor considered sampling risk.
- Any qualitative factors considered significant in making the sampling, selections, assessments, and judgments. (This may include multiple programs or other factors.)
- A summary of the overall conclusion (if not evident from the results).

The lack of sampling documentation is one of the most common topics in letters of comments for peer reviews. Both AU-C 230.08 and the Yellow Book state that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand the nature, timing, extent, and results of the audit procedures performed. In addition, as discussed in the previous paragraph, AU-C 230.09 states that documentation of audit procedures, including those involving sampling, should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents. Also, AU-C 330.30 states that the auditor should document the nature, timing, and extent of the further audit procedures (the test of control in this instance) and the linkage of those procedures to the assessed risks at the relevant assertion level. Thus, the audit documentation needs to document all important aspects of the engagement, including the sampling and other selection criteria used, and be sufficiently detailed to permit reasonable identification of the work done and conclusions reached.

To comply with the AU-C 230 requirements, the auditor's documentation of control tests should also include identification of the selected sample items. AU-C 230.A14 includes two examples of identifying specific items tested that the authors believe are relevant to tests of controls using sampling. One is to identify the documents selected for testing by their dates and document sequence numbers. The other applies when systematic selection is used; the auditor documents the source of documents, the starting point, and sampling interval.

Concluding on Tests of Controls Using Sampling

The auditor's overall conclusion about the effect of the results of the tests of controls on the assessed level of control risk of noncompliance, the risks of material noncompliance, and on the nature, timing, and extent of compliance tests requires professional judgment. For example, if the sample results and other relevant audit evidence support a planned low assessed level of control risk of noncompliance, the auditor might not need to modify planned compliance tests. However, if the sample results do not support the planned low assessed level of control risk of noncompliance, the auditor considers either performing additional tests of other controls or increasing the assessed level of control risk of noncompliance and revising the nature, timing, or extent of the planned compliance tests accordingly.

USING AUDIT SAMPLING IN SUBSTANTIVE TESTS OF COMPLIANCE WITH LAWS AND REGULATIONS

Compliance with laws and regulations and the provisions of contracts or grant agreements is necessary for an entity to recognize an amount as revenue earned or to receive reimbursement for an expense from a grantor agency such as HUD. Therefore, compliance with laws and regulations and the provisions of contracts or grant agreements has a direct effect on line-item amounts in the financial statements of a HUD-assisted entity. Also, the HUD audit guide and OMB's Uniform Guidance require the auditor to test an entity's compliance with compliance requirements, noncompliance with which could have a direct and material effect on each major program. These substantive tests of compliance may or may not involve the use of audit sampling.

The nature of some specific compliance requirements lends them to sampling. Relative to audits of for-profit entities, the HUD audit guide's suggested audit procedures incorporate the use of sampling for several compliance areas. Those compliance areas, such as Cash Disbursements, usually possess documentary evidence of compliance and involve large populations. Other compliance areas, because of the small population involved or the type of evidence of compliance available, do not lend themselves to sampling. Exhibit 2-2 in Lesson 2 provides a list of compliance requirements that typically are not tested using audit sampling and compliance requirements that typically are tested using audit sampling.

Objective of the Tests

The primary objective of tests of compliance in a HUD audit is to determine whether the auditee has complied with the direct and material compliance requirements applicable to each of its major programs. The compliance audit results in the auditor issuing an opinion on compliance for each major program. The auditor gathers sufficient appropriate audit evidence by planning, performing risk assessment procedures, and performing tests of transactions and other such auditing procedures necessary in support of the entity's compliance with program requirements. This process was described in Lesson 2.

Substantive Tests of Transactions

The purpose of compliance tests in a compliance audit is to determine whether any noncompliance exists that could have a material effect on the financial statements and to provide a basis for providing an opinion on major programs. As a result, tests of compliance are considered substantive tests that usually are achieved by examining supporting documentation. This type of audit test is frequently applied using audit sampling in much the same manner as other types of substantive tests.

When Is Audit Sampling Appropriate?

The HUD audit guide and the Compliance Supplement identify compliance requirements and suggest audit procedures for those requirements. However they do not specify the extent of testing required. Instead, the auditor uses professional judgment to determine the extent of the tests of compliance by considering several factors, including the results of tests of the controls used to administer HUD programs as discussed in Lesson 2.

By their nature, some compliance requirements lend themselves to sampling. Such requirements leave documentary evidence of compliance and involve large populations. Others, because of the small population involved or the type of evidence of compliance available, do not lend themselves to sampling.

Terminology for Sampling in Tests of Compliance

The following sampling terms are unique to compliance testing:

- *Exception*—Departure from laws, regulations, and the provisions of contracts or grant agreements being tested.
- *Tolerable Exception Rate*—The maximum rate of compliance exceptions the auditor is willing to accept.
- *Expected Exception Rate*—The rate of exceptions the auditor expects in the population.

Designing the Sample

When designing a particular sample, the auditor should consider the purpose of the audit procedure. Thus, because each compliance area has a different purpose, samples, and the characteristics of the population from which the sample will be drawn, would be separately considered. It is also useful to consider whether the compliance requirement is transaction-related or program-related.

HUD provides specific guidance about the sampling methodology that is to be used in audits performed in accordance with the HUD audit guide. Those requirements, which should be followed when sampling is used in audits of for-profit entities, are included in Appendix A to Chapter 1 of the HUD audit guide.

In Single Audits of nonprofit HUD entities, the auditor may use the guidance in Paragraph 11.72 of the GAS/SA Audit Guide for determining the sample size. The suggested sample sizes are designed to provide a high level of assurance. Auditors that perform Single Audits of HUD-assisted entities will find extensive discussion about sampling in audits performed in accordance with the OMB's Uniform Guidance in *PPC's Guide to Single Audits*.

Sampling Guidance in the HUD Audit Guide—For-profit Audits

Required Use of Attribute Sampling. Paragraphs 1-4 and 3-4 of the HUD audit guide specify the attribute sampling method as the appropriate sampling method when testing compliance in accordance with the guide. Appendix A to Chapter 1 of the HUD audit guide establishes minimum sample sizes that must be used when performing compliance testing in accordance with the guide. Since audits of nonprofit HUD entities are performed in accordance with OMB's Uniform Guidance rather than the HUD audit guide, these provisions do not have to be followed on nonprofit HUD audits. However, it is acceptable to follow these provisions since they do not conflict with the sampling guidance in the Uniform Guidance.

Appendix A to Chapter 1 of the HUD audit guide provides an overview of attribute sampling. It specifies minimum sample sizes, details the items to be documented in the audit workpapers when performing a sample, and provides guidance on how to evaluate and report the results.

In the HUD compliance audit, the population for a test of compliance may consist of a class of transactions that are subject to the HUD audit guide's compliance requirements for a specific major program. The dollar amounts of the transactions may vary significantly; therefore, the auditor considers such variation when determining an appropriate sample size for the test. Other populations that may be subject to sampling consist of tenant lease files, HUD-required reporting packages, or applicants from the project's waiting list. When audit sampling is involved, judgment is needed to define the audit population.

The HUD audit guide emphasizes the importance of properly defining the objective of the compliance test and defining the population in the sample by pointing out that the auditor should understand and document what attribute(s) and/or assertion(s) are being tested. The HUD audit guide's suggested audit procedures are designed to test the assertion that the entity has complied with the applicable compliance requirement. For example, the audit procedures in the HUD audit guide's Tenant Application, Eligibility and Recertification audit area are designed to test whether the auditee meets the following specific requirement:

> Owners who participate in HUD's rent subsidy programs are responsible for accepting applications, maintaining a waiting list, determining eligibility, calculating the tenant's contribution toward rent and utilities, calculating subsidy, and recertifying the tenant annually in accordance with HUD requirements.

The HUD audit guide's suggested audit procedures for compliance with this requirement include inspecting a sample of tenant files for evidence of compliance with specific HUD requirements. When applying sampling methods, it is important to document the sampling unit; the individual item, such as a lease file, is subject to sampling. Evidence of the tenant's annual recertification is an attribute of the lease file that is tested as part of the compliance test.

The HUD audit guide states that the samples selected for testing each of the applicable compliance requirement areas should be considered a separate population and samples should be selected accordingly. However, in some cases the sample selected may be used to test multiple attributes within each compliance requirement. Additionally, auditors must assess the control environment at entities with multiple locations. If controls at the different locations are significantly different, each location must be considered a separate population.

Determining Sample Size. Sample sizes are determined by the auditor using professional judgment and taking into consideration the assessment of inherent risk and control risk. The objectives of compliance auditing procedures are to provide sufficient, appropriate audit evidence to reasonably assure the detection of material noncompliance with direct and material requirements applicable to major programs. Therefore, the auditor selects sample sizes that will provide appropriate evidence for that purpose. Auditors of for-profit entities ensure that such sample sizes meet the minimum requirements set forth in Appendix A to Chapter 1 of the HUD audit guide.

When performing attribute sampling, monetary materiality, such as planning materiality, and tolerable misstatement amounts are not considered. Instead, the desired confidence level, tolerable exception rate, expected exception rate (deviation), and size of the population are used. Appendix A to Chapter 1 of the HUD audit guide states that the auditor needs to obtain a high degree of assurance from the attribute sample by using a confidence level of 90% or 95%. It also states that a tolerable exception rate of 5% to 10% is acceptable. The minimum sample sizes in the HUD audit guide reflect no deviations are expected to be found in the sample.

The HUD audit guide includes a minimum sample size table for populations over 250 that equates (a) a 90% confidence level with a low to normal importance or significance of the attribute being tested, and (b) a 95% confidence level with a high importance or significance, as determined by auditor judgment based on knowledge of the population. Those values combined with tolerable rates of 5% and 10% yield minimum sample sizes of 25 to 65. However, certain qualitative factors may cause the auditor to increase the sample size based on professional judgment. These qualitative factors might include, among other things:

- First year audit for the auditor
- Large decentralized entities
- Numerous significant deficiencies, material weaknesses, or audit findings in prior audits
- High number of past findings, including significant deficiencies and material weaknesses
- Poor internal controls
- High activity volume
- High employee turnover

These factors also affect the level of inherent risk that violation of laws and regulations could have a material effect on HUD programs. In assessing inherent risk of noncompliance, the auditor also considers the results of other procedures performed as part of the audit of the financial statements. The assessment of the risk of material noncompliance (i.e., the combined inherent and control risk) for purposes of determining the extent and nature of compliance testing, as well as the assessment of inherent risk for compliance requirements applicable to HUD programs, should be documented.

The HUD audit guide also provides guidance for sample sizes for small populations of less than 250 items. Generally, sample sizes of at least 10% of the items in the population should be examined. Appendix A to Chapter 1 of the HUD audit guide indicates that if exceptions are observed, the auditor needs to investigate the nature and cause of the exception, including performing additional procedures if necessary, to determine the materiality of the compliance findings, significant deficiencies, or material weaknesses in internal control. Though the exceptions must be reported, HUD does not require that the testing be expanded. The AICPA Guide, *Audit Sampling*, suggests that the auditor double the sample size. If a greater number of exceptions are noted than were planned for, doing so might allow the auditor to continue to use the sample as a basis for opining on the applicable compliance requirement.

The auditor should have the flexibility to plan for deviations. If more exceptions are noted than were planned for, the auditor chooses a new sample corresponding to the new exception level or increase the size of the existing sample by doubling it. The sample results must ultimately support the auditor's opinion on compliance with the direct and material requirements applicable to the major program.

Selecting the Sample. In tests of compliance under the HUD audit guide, each compliance area is considered to be a separate population. The separate samples provide clear evidence of the tests performed, the results of those tests, and the conclusions reached, which support the auditor's opinion on each major program. The auditor needs to ensure that all items in the population have a chance to be selected. Accordingly, the auditor needs to determine that the sample population actually includes all of the items comprising the population. If necessary, the auditor may need to stratify the population and allocate the sample size to the specific groups. The auditor's consideration of the completeness of the sample population should be documented.

In tests of compliance with the administrative requirements and cost principles under the Uniform Guidance, transactions to be tested for a major program might include expenditures from federal awards subject to the pre-Uniform Guidance requirements, as well as expenditures from federal awards subject to the requirements in the Uniform Guidance. When this situation occurs, the auditor would use both Part 3.1 and Part 3.2 of the Compliance Supplement to test applicable compliance requirements.

Projecting the Sample Results

The GAS/SA Audit Guide, Paragraph 11.116 indicates that the nature and cause of noncompliance the auditor identifies should be evaluated, regardless of whether the sample is statistical or nonstatistical. The exceptions need to be evaluated to determine whether to report findings of material noncompliance and may affect the overall opinion on compliance.

In addition, because the auditor is required to estimate likely questioned costs in a HUD compliance audit, it may be necessary to project the sample results when determining the effect on the auditor's opinion on compliance and whether an audit finding has to be reported. Neither the HUD audit guide nor OMB's Uniform Guidance require that the auditor expand the scope of a sampling application (i.e., test additional transactions) to definitely determine the total questioned costs. Instead, the auditor is only required to consider the effect of likely questioned costs on the compliance opinion and report an audit finding when the estimate of questioned costs is material to the major program. [For nonprofit audits, likely questioned costs in excess of $25,000 trigger reporting of known questioned costs for the particular compliance requirement. However, only the actual (known) questioned costs resulting from the items tested need to be reported as an audit finding.] The auditor should document the noted exceptions (i.e., the questioned costs).

Although compliance testing often involves monetary amounts, the auditor also has to consider nonmonetary compliance attributes (e.g., a report is submitted on a timely basis). The auditor should document exceptions noted in testing nonmonetary compliance attributes and consider whether the finding should be included in the schedule of findings and questioned costs. The GAS/SA Audit Guide Paragraph 11.117 explains that calculating the exception rate for a nonmonetary compliance test sample requires dividing the number of exceptions by the sample size. For example, three exceptions for a sample of 60 would result in an exception rate of 5% (3/60). The exception rate in the sample would generally be the auditor's best estimate of the exception rate in the population from which it was selected.

The GAS/SA Audit Guide, Paragraph 11.120 explains that for monetary exceptions, two different approaches are commonly used to project questioned costs depending on the characteristics of the exceptions.

a. The first approach is used if the monetary exceptions are 100% errors (e.g., the entire sampling unit contains all unallowable costs) and are from a population of similar-sized transactions. In this circumstance, the technique used to determine nonmonetary exception rates can be used to estimate likely questioned costs. For example, if three exceptions are observed in a sample of 60, the exception rate is 5% (3/60). If the three exceptions were 100% errors and the population consisted of homogeneous transactions, the 5% exception rate would be applied to the total dollar amount of the population to estimate likely questioned costs. Thus, if the total value of the sampling population was $800,000, the likely questioned costs would be $40,000.

b. The second approach applies the questioned costs observed in the sample to the population. For example, if $450 of questioned costs are noted in a sample of expenditures that totaled $15,000, the questioned cost rate is 3% (450/15,000). If the total recorded amount in the expenditures population is $1,000,000, then projected likely questioned cost is $30,000 ($1,000,000 × 3%). This approach is particularly useful when a sampling unit is only partially incorrect.

If a compliance exception does not meet the criteria for reporting as a finding, the auditor would typically want to obtain assurance that the exception can be omitted from the schedule of findings and questioned costs. While the auditor is not required to expand the sample in the case of exceptions, the auditor might perform additional procedures to support the conclusion that the exception is not a finding. In all cases where an initial exception is determined not to be a finding, the auditor should document the rationale for omitting the exception from the schedule of findings and questioned costs.

Paragraph 11.127 of the GAS/SA Audit Guide explains that a compliance exception indicates a potential deficiency in internal control over compliance. Thus, the auditor should relate exceptions from compliance testing to the results from the internal control testing when forming a conclusion about compliance and internal control over compliance.

Considering Sampling Risk Associated with Compliance Testing

The GAS/SA Audit Guide, Paragraph 11.123 states that the auditor should give appropriate consideration to sampling risk when evaluating sample results from a test of compliance. If the estimated population exception rate (i.e., the sample exception rate) for nonmonetary attributes is less than the tolerable exception rate for the population, or if the estimate of likely questioned costs is less than the tolerable error for a monetary population, the auditor would consider whether a similar result might be obtained if the true exception rate or questioned costs for the population exceeds the tolerable rate or tolerable error, respectively, for the population. It is important to note that smaller samples have greater uncertainty or sampling risk. The GAS/SA Audit Guide, Paragraph 11.124 explains that it is generally appropriate to conclude that the sample results do not support an acceptable level of compliance if the rate of exceptions or likely questioned costs in the sample exceeds the expected exception rate used in designing the sample.

If more compliance exceptions are identified than were planned for, the planned audit objective has not been met, and due to sampling risk there is likely to be an unacceptably high risk that the true exception rate in the population exceeds the tolerable rate. Paragraph 11.125 of the GAS/SA Audit Guide explains that after considering the number and magnitude of exceptions and the reasons for them, the auditor might decide to either expand testing or to perform other tests that include sufficient additional items to reduce the risk of material noncompliance to an acceptable level. However, instead of expanding the scope of testing, the auditor could choose to report the exceptions as an audit finding and evaluate the effect that the sample results have on the assessed level of risk of material noncompliance and the overall compliance opinion.

It is especially important to consider sampling risk when the projected likely questioned cost is close to program materiality (or, for audits of nonprofit entities, close to $25,000, which is the Uniform Guidance reporting threshold). In this situation, the auditor would usually conclude that there is an unacceptable risk that the true questioned costs exceed the reporting threshold. Even when the projected likely questioned costs are significantly less than the reporting threshold, the auditor should consider sampling risk (that is, the risk that a similar result might be obtained even though the actual questioned costs for the population are material).

Evaluating Sample Results

The auditor's evaluation of the sample needs to be considered along with other relevant audit evidence when forming a conclusion about program compliance. The auditor uses sampling when the items selected are expected to be representative of the population and, thus, likely to provide a reasonable basis for conclusions about the population. When supporting documentation cannot be located for selected items, the auditor cannot apply the planned audit procedures. In this situation, the treatment of unexamined items will depend on their effect on the auditor's evaluation of the sample results.

When testing compliance in a HUD audit, the auditor is concerned not only with the dollar amount of noncompliance but also the rate of noncompliance in the population. Therefore, the auditor considers not only the dollar amount of questioned costs but also the number of items of noncompliance identified. Even though the dollar value of questioned costs may be insignificant, if it results from numerous instances of small dollar items of noncompliance, the auditor needs to consider the overall effect on determining whether the program is or is not in compliance. The qualitative aspects of the instances of noncompliance are also considered. For example, the auditor also considers how the inability to examine items affects the assessment of the risks of material misstatement due to fraud, the assessed level of control risk that the auditor expects to be supported, or the degree of reliance on management representations.

Considering Qualitative Characteristics

Size and frequency of noncompliance in a sampling application are not the only factors that are considered when evaluating sample results. An auditor should also consider the following qualitative aspects of the noncompliance (questioned costs):

a. The nature and cause of any questioned costs:

    (1) Do the questioned costs result from an error (unintentional) or is it from a possible fraud (intentional)?

    (2) If the noncompliance is the result of an error, is it due to misunderstanding of instructions or carelessness?

b. The possible relationship of questioned costs to other phases of the audit.

Documenting the Compliance Sampling Procedures and Conclusions Reached

Although AU-C 230 and AU-C 530 do not impose specific documentation requirements for audit sampling, the standards require that audit documentation be sufficient to document that the applicable GAAS standards have been observed. In other words, the audit documentation should show that AU-C 230 and AU-C 530 have been complied with. The lack of sampling documentation is one of the most common topics in letters of comments for peer reviews and findings in quality control reviews. AU-C 230.08 states that the audit documentation should be sufficient to enable an experienced auditor with no connection with the audit to understand:

- The nature, timing, and extent of auditing procedures performed to comply with GAAS and applicable legal and regulatory requirements (for example, the HUD audit guide or OMB's Uniform Guidance).
- The results of the audit procedures and the audit evidence obtained.
- Significant findings or issues, the conclusions reached on them and significant professional judgments made in reaching the conclusions.

Documentation of audit procedures, including those involving sampling, should include identifying characteristics of the specific items that were tested. This requirement specifically includes tests of the operating effectiveness of controls and substantive tests of details involving inspection of documents. Thus, the audit documentation should document all important aspects of the engagement, including the sampling and other selection criteria used, and should be sufficiently detailed to permit reasonable identification of the work done and conclusions reached.

In addition to the requirements of AU-C 230, AU-C 935.40–.41 states that the auditor should document the risk assessment procedures performed, including procedures to obtain an understanding of internal control over compliance, and the auditor's responses to the assessed risks of material noncompliance, procedures performed to test compliance with the applicable compliance requirements, and the results of those procedures, including any tests of controls over compliance.

Documentation of sampling in a HUD compliance audit is influenced by several factors, including the size and complexity of the entity, the nature and complexity of the compliance requirements and of internal control over compliance, and the entity's past experience relative to compliance.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

21. Which of the following may indicate that a federal program has a higher inherent risk of noncompliance?

    a. The program has existed for numerous years.

    b. The program operates systematically and has routine transactions.

    c. The entity has adhered to the program's strict terms and conditions.

    d. Processes associated with the compliance requirement substantially changed this year.

22. What is the term for the maximum amount of compliance exceptions than a compliance auditor is willing to accept when using audit sampling?

    a. Exception.

    b. Expected exception rate.

    c. Tolerable exception rate.

    d. Tolerable deviation rate.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

21. Which of the following may indicate that a federal program has a higher inherent risk of noncompliance? **(Page 217)**

    a. The program has existed for numerous years. [This answer is incorrect. As mentioned in Paragraph 11.65 of the GAS/SA Audit Guide, one factor that might indicate a federal program has higher inherent risk of noncompliance is if the program is *new*.]

    b. The program operates systematically and has routine transactions. [This answer is incorrect. Per Paragraph 11.65 of the GAS/SA Audit Guide, a federal program will have a higher risk of noncompliance if it involves judgment or complex processing. Nonroutine, nonsystematic, and manual transactions will have higher risk than routine, systematic, and programmed transactions.]

    c. The entity has adhered to the program's strict terms and conditions. [This answer is incorrect. As discussed in Paragraph 11.65 of the GAS/SA Audit Guide, if the entity did *not* adhere to applicable laws and regulations or the terms and conditions of the federal award program in prior years, this could indicate that the program has a higher inherent risk of noncompliance, even if the problems have been addressed.]

    d. **Processes associated with the compliance requirement substantially changed this year. [This answer is correct. According to AU-C 935.11, *inherent risk of noncompliance* is a compliance requirement's susceptibility to noncompliance that could be material (individually or when combined with other instances of noncompliance) without consideration of related internal controls. Paragraph 11.65 of the GAS/SA Audit Guide provides a list of factors that might indicate a federal program has higher inherent risk of noncompliance. One factor included on that list is there is more risk when there has been a substantial change in the policies, processes, or personnel associated with the compliance requirement.]**

22. What is the term for the maximum amount of compliance exceptions than a compliance auditor is willing to accept when using audit sampling? **(Page 222)**

    a. Exception. [This answer is incorrect. This is defined as a departure from laws, regulations, and the provisions of contracts or grant agreements being tested.]

    b. Expected exception rate. [This answer is incorrect. This is defined as the rate of exceptions the auditor expects in the population.]

    c. **Tolerable exception rate. [This answer is correct. There are certain terms that are unique to sampling in tests of compliance. One of them is *tolerable exception rate,* which is defined as the maximum rate of compliance exceptions that the auditor is willing to accept.]**

    d. Tolerable deviation rate. [This answer is incorrect. This is defined as the maximum rate of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk of noncompliance.]

SPECIAL CONSIDERATIONS THAT MAY APPLY IN AUDITS OF NONPROFIT HUD-ASSISTED ENTITIES

Should Nonprofit Recipients of HUD Assistance Follow the HUD Audit Guide or OMB's Uniform Guidance?

Chapter 1 of the HUD audit guide, Paragraph 1-2, explains that nonprofit entities are subject to the audit requirements in OMB Circular A-133 (now replaced with the Uniform Guidance), and that auditors should normally use the Compliance Supplement, not the HUD audit guide, when auditing nonprofit HUD-assisted entities. However, when a HUD program is not included in the Compliance Supplement but is included in the HUD audit guide, the auditor should use the audit procedures in the HUD audit guide and the guidance in part 7 of the Compliance Supplement when developing the audit program.

Compliance Audit Differences

The Uniform Guidance does not mandate any audit requirements for the financial statement audit beyond those of *Government Auditing Standards*. However, the compliance audit approach may differ because of other aspects of the Single Audit, as explained below:

- The Uniform Guidance, at 2 CFR section 200.514(c), requires the auditor to obtain an understanding of internal control over federal programs "sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs" and to test such internal control even if it would not be efficient to do so to support a reduction in the extent of substantive tests in the audit of the financial statements.
- The Uniform Guidance requires that transactions be selected as part of the tests of compliance with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on major programs. While doing this, the auditor may also test the accuracy of the amount and classification (i.e., test the financial statement assertions related to the transaction).
- Requirements of the Single Audit might cause the auditor to test *transactions* making up an account total where a test of the *balance* would suffice for financial audit purposes. For example, an effective analytical test of total payroll of a particular department might yield sufficient audit evidence, but the auditor might still test payroll transactions because of the Single Audit need to determine that they were allowable expenditures properly chargeable against a particular major federal program.
- Sampling in a compliance audit differs from sampling in a financial statement audit. Chapter 11 of the GAS/SA Audit Guide establishes different sampling terminology and methodology than used in the financial statement audit environment. It also provides suggested minimum sample sizes for a compliance audit, which are determined differently for tests of controls than for tests of compliance. The sampling methodology is based on attribute sampling and will generally result in larger sample sizes.

Data Collection Form and Single Audit Reporting Package

To streamline the distribution of audit reports and improve the government-wide collection and analysis of Single Audit results, the Uniform Guidance, at 2 CFR section 200.512, provides for a form, referred to as the *data collection form*, to be prepared at the completion of each Single Audit and submitted to the federal clearinghouse designated by the OMB. The data collection form is submitted along with a Single Audit reporting package, which includes the following:

- Financial statements.
- Schedule of expenditures of federal awards (SEFA), presented as supplementary information to the basic financial statements.
- Summary schedule of prior audit findings.
- Auditor's reports, including the schedule of findings and questioned costs.
- Corrective action plan.

Unaudited financial statements should not be submitted to the Federal Audit Clearinghouse.

HUD Reporting Package. HUD has developed an electronic submission template that incorporates the reporting package information and the HUD required information.

Cognizant/Oversight Agency for Audit

The Uniform Guidance establishes a cognizant agency for audit for recipients that expend more than $50 million in federal awards annually. An oversight agency for audit is established for those that expend less than $50 million annually. In both cases, the federal agency performing this role is normally the agency providing the most direct federal funding. Thus, for most nonprofit HUD-assisted entities, that agency will be HUD. The oversight/cognizant agency for audit is generally tasked with representing all funding federal agencies by providing technical advice to the recipient and its auditor, notifying the auditor of deficiencies in reports, and following up on findings and questioned costs. The Uniform Guidance, at 2 CFR section 200.513, details all of the responsibilities of the cognizant/oversight agency for audit.

Major Program Determination

Total federal awards expended must be segregated into programs to determine major programs. A program consists of all assistance provided under the same Assistance Listing number. A "cluster" of programs is also considered a single program for purposes of determining major programs. The Compliance Supplement details the Assistance Listing numbers of programs that can be clustered together for this purpose. Nonprofit project owners should contact HUD for assistance in determining unknown Assistance Listing numbers for their programs.

Single Audit Risk-based Approach. A risk-based approach for determining which federal programs are major programs is prescribed in 2 CFR section 200.518. Using a risk-based approach requires the auditor to focus on programs that have a higher risk of noncompliance occurring, instead of only focusing on programs with large dollar expenditures. The approach must include consideration of:

- Current and prior audit experience.
- Oversight by federal agencies and pass-through entities.
- Inherent risk of the program.

2 CFR section 200.519(a) states "the auditor's determination [of federal program risk] should be based on an overall evaluation of the risk of noncompliance occurring that could be material to the Federal program." Auditors should use professional judgment and must consider risk criteria such as that provided in the Uniform Guidance. Auditors may also consult with management and the federal awarding agency or pass-through entity concerning particular programs.

The Uniform Guidance describes a four-step process for determining major programs. If major programs are determined and documented in accordance with 2 CFR section 200.518, the auditor's judgment in applying the risk-based approach must be presumed correct. The auditor may wish to use practice aids to assist in determining major programs for nonprofit HUD-assisted entities in audits conducted under the Uniform Guidance. Many such entities may expend federal awards under only one program. In such cases, completion of certain practice aids may not be necessary.

Percentage of Coverage Rule and Low-risk Auditee Exception. In determining major programs, additional programs must be audited as major until at least 40% of total federal awards expended are classified as major programs. However, this percentage can be reduced to 20% for entities that qualify as "low-risk auditees" based on the criteria specified in 2 CFR section 200.520.

Internal Control Considerations

In addition to GAAS and Yellow Book requirements related to internal control, 2 CFR section 200.514(c) states that the auditor must perform procedures to obtain an understanding of internal control over federal programs "sufficient to plan the audit to support a low assessed level of control risk of noncompliance for major programs." Paragraph

9.13 of the GAS/SA Audit Guide explains that the auditor's understanding should be sufficient to assess the risks of material noncompliance with each direct and material compliance requirement for each major program and should encompass the five components of internal control.

Part 3 of the Compliance Supplement includes suggested audit procedures for testing internal control. However, Part 1 of the Compliance Supplement clarifies that "the auditor must determine the specific procedures to test internal control on a case-by-case basis, considering factors such as the non-Federal entity's internal control, the compliance requirements, the audit objectives for compliance, the auditor's assessment of control risk, and the audit requirement to test internal control as prescribed in 2 CFR part 200, subpart F."

If internal controls are likely to be ineffective in preventing or detecting noncompliance, tests of controls are not required for those compliance requirements. In that case, the auditor must report the internal control deficiency as a significant deficiency or material weakness in the Schedule of Findings and Questioned Costs, assess the control risk at the maximum, and consider whether additional compliance tests are necessary due to the ineffective internal control.

The Uniform Guidance only requires that a low assessed level of control risk of noncompliance be *planned for* and that *testing of controls be performed* based on that plan. It does not require, however, that a low assessed level of control risk of noncompliance be achieved. In other words, if deviations in the tests of controls are found, additional selections would not have to be tested. The auditor would only need to report the results of the testing and perform compliance testing based on assessing the control risk at the level actually achieved (either high or moderate), depending on the sample size and number of deviations found. If, however, the control testing supports assessing the control risk at less than high (either low or moderate), the auditor may consider reducing the substantive testing accordingly. The auditor's understanding of internal control over major HUD programs for nonprofit HUD entities should be documented.

Consideration of Results of Prior Years' Tests of Controls. Because of the Uniform Guidance requirement to perform the testing of internal control to support a low assessed level of control risk of noncompliance, internal controls over compliance for federal programs should be tested each year. However, the results of prior years' tests of controls might provide important information to consider when planning current year tests of controls. If the results of prior tests of controls prevented the auditor from assessing a low level of control risk of noncompliance, the auditor might decide to expand testing in the current audit period. Useful information also might be obtained by testing changes in internal control that were intended to eliminate deficiencies noted in the previous year. However, if the auditor concluded in the prior year that internal control over compliance for one or more compliance requirements was ineffective and the auditee has not made changes in its internal control over compliance, the auditor might conclude that controls are likely to be ineffective. In this situation, the auditor could choose not to plan and perform tests of controls and must report a significant deficiency or a material weakness in internal control over compliance.

Compliance Supplement Guidance. Part 6 of the OMB Compliance Supplement addresses the objectives, principles, requirements for internal control, the importance of internal control concepts, and the components of internal control based on the *Standards for Internal Control in the Federal Government* (the "Green Book") and the COSO's *Internal Control—Integrated Framework* (COSO Framework). It provides an overview of internal control; requirements; and illustrates internal control for each of the five components of internal control to assist nonfederal entities and their auditors in complying with their respective requirements based on the Green Book. Part 6 is not a checklist of required internal control characteristics; however, it may be helpful when planning and performing the Uniform Guidance compliance audit.

Compliance Requirements

2 CFR section 200.514(d)(2) directs the auditor to the Compliance Supplement to determine the compliance requirements for major program testing. The purpose of the Compliance Supplement is to assist auditors in planning and performing audits in accordance with the Single Audit Act and the Uniform Guidance. In doing so, the Compliance Supplement provides an important source of information for auditors to understand a program's objectives, procedures, and compliance requirements and to assist the auditor in determining appropriate audit objectives and audit procedures for federal programs.

Updates. The Compliance Supplement has been revised annually since 1997. The OMB 2022 Compliance Supplement supersedes the 2021 Compliance Supplement and its addenda and is effective for audits of fiscal years beginning after June 30, 2021. The 2022 Compliance Supplement has been revised to add new programs, delete several programs, change existing programs, clarify auditing guidance, and make various technical corrections. Auditors should monitor the OMB website and the GAQC website at **https://us.aicpa.org/interestareas/governmentalauditquality** for any potential future changes to the Compliance Supplement. PPC's *SMART Practice Aids®—Single Audit Suite* will also assist auditors in determining appropriate compliance requirements, objectives, and audit procedures for single audits when using the 2022 Compliance Supplement.

Beginning with the 2019 Compliance Supplement, OMB limited the number of compliance requirements subject to the audit to six. (For this purpose, the requirements relating to A. Activities Allowed and Unallowed, and B. Allowable Costs and Cost Principles are treated as one requirement.) Many auditors are referring to this approach in the Compliance Supplement as the six-requirement mandate or Pick Six. With the six-requirement mandate and the Part 2 definitions, there will be compliance requirements that are direct and material to the program that have an "N" in the box in the matrix, and thus will not be subject to audit. For programs included in the Part 2 Matrix, auditors should carefully review the matrix when planning the single audit and consider whether revisions are needed to their testing approach and if changes could affect other compliance activities (e.g., subrecipient monitoring). Additionally, auditors should carefully review the guidance in Part 1 of the Compliance Supplement about the safe harbor status and responsibility for updating compliance requirements. The six-requirement mandate does not apply to programs not included in the 2022 Compliance Supplement. Auditors should continue to use the Part 7 guidance to identify compliance requirements that are applicable to programs not included in the Compliance Supplement.

The GAS/SA Audit Guide, Paragraph 10.19, indicates that for the types of compliance requirements that are identified as subject to the audit, the auditor should determine, using professional judgment, which of those may have a direct and material effect on each of the auditee's major programs. Even though a "Y" indicates that a compliance requirement is subject to audit, it may not apply to a particular auditee, either because that entity does not have activity subject to that type of compliance requirement or the activity could not have a direct and material effect on a major program. For examples, a federal program may be designed such that subawards may be made to subrecipients; and thus, the matrix in Part 2 would identify the subrecipient monitoring type of compliance requirement as subject to audit. However, the auditee may not have made any, or made only an immaterial amount of, subawards from the federal program. Thus, the auditor may determine that noncompliance with the subrecipient monitoring type of compliance requirement would not have a direct or material effect on the major program (even though it was identified as subject to audit in the Part 2 matrix). No testing would be required on types of compliance requirements not considered direct and material. Paragraph 10.20 of the GAS/SA Audit Guide reminds auditors, in making a determination not to test a type of compliance requirement identified as subject to audit for a particular program, the auditor should conclude, and document the basis for such conclusion, either that the requirement does not apply to the particular auditee or that noncompliance with the requirements could not have a direct and material effect on a major program.

The Note to Paragraph 10.20 of the GAS/SA Audit Guide indicates that quality reviews have shown that some auditors are not documenting their thought process and conclusions about instances where a compliance requirement is noted as being subject to audit in the Compliance Supplement; however, it is not tested by the auditor. In other instances, documentation may have been provided, but it is too minimal to be considered adequate. A common scenario found is where the auditor indicates one or more compliance requirements is "not applicable" or "immaterial" without further explanation. This level of documentation does not provide adequate documentation of the auditor's considerations in reaching their conclusion not to test a type of compliance requirement identified in the Compliance Supplement as subject to audit for a particular program. Additional quality control concerns about documenting compliance requirements are discussed below.

Because the Compliance Supplement is updated annually, it is important to use the correct update for the year being audited. As previously noted, auditors will use the 2022 Compliance Supplement for audits of fiscal years beginning after June 30, 2021. See **www.whitehouse.gov/omb/office-federal-financial-management/** for the 2022 Compliance Supplement. For audits of previous years, auditors should use the version of the Compliance Supplement that was in effect at that time. The OMB website also includes previous years' versions. (Note that the two addenda that were issued to the 2021 Compliance Supplement are posted on the Chief Financial Officers Council (CFOC) website at **www.cfo.gov/2021-addendum-1and2/**. The OMB has currently only provided a single PDF file of the 2022 Compliance Supplements due to current restrictions/limitations on OMB website content.

Documenting Compliance Requirements Subject to Audit That Are Direct and Material for Federal Programs Included in the Compliance Supplement. For federal programs that are included in the Compliance Supplement, the auditor should document in the workpapers the types of compliance requirements that the matrix in Part 2 of the Compliance Supplement indicates are subject to the audit for the major program. This may be accomplished by including a copy of the relevant page of the matrix (from Part 2 or the applicable row of the matrix presented in Parts 4 and 5 for each program/cluster) in the workpapers, developing a matrix that reflects only the auditee's major programs, or preparing a memorandum. In addition, the auditor should document his or her consideration supporting the decision as to which compliance requirements that are subject to the audit could have a direct and material effect on the program and therefore should be tested. Considerations and conclusions reached should be documented.

Documenting Compliance Requirements Subject to Audit That Are Direct and Material for Federal Programs Not Included in the Compliance Supplement. For federal programs that are not included in the Compliance Supplement, the auditor should document in the workpapers the types of compliance requirements that are applicable to the audit for the major program. The auditor should have also documented his or her consideration supporting the decision as to which compliance requirements could have a direct and material effect on the major program and therefore should be tested. Auditors should document their considerations and conclusions reached in a practice aid, or refer to a memo.

Quality Control Concerns about Documenting Compliance Requirements. A Note at Paragraph 10.76 of the GAS/SA Audit Guide points out that some quality control reviews performed by federal agencies had findings in which audit documentation did not provide sufficient evidence that work was performed to support the auditor's opinion on compliance for one or more major programs. In certain cases, the audit documentation (a) did not contain evidence that the auditor tested certain compliance requirements identified as subject to audit in the Part 2 Matrix of Compliance Requirements for a major program or (b) did not explain why certain compliance requirements identified in the Compliance Supplement as subject to audit in the Part 2 Matrix of Compliance Requirements were determined not to be direct and material to a major program. Among other things, the auditor should document the individual tests performed and the results of those tests. The concerns discussed reflect the terminology used in the Compliance Supplement before the changes made in the 2020 Compliance Supplement.

Programs Included in the Compliance Supplement. Exhibit 3-2 lists the Section 202 and Section 811 programs and certain Section 8 project-based programs that are included in the Compliance Supplement. Though the compliance requirements, objectives, and suggested audit procedures are included in the Compliance Supplement, the auditor should perform reasonable procedures to ensure that the compliance requirements are current and that the individual contract or grant agreement does not contain other material requirements. Auditor judgment is required to determine that the audit procedures achieve the desired objective.

Exhibit 3-2

Multifamily Programs Included in the Current Compliance Supplement—Nonprofit Audits

Assistance Listing	PROGRAM TITLE
14.157	Supportive Housing for the Elderly (Section 202)
14.181	Supportive Housing for Persons with Disabilities (Section 811)
14.182	Section 8 New Construction and Substantial Rehabilitation
14.195	Section 8 Housing Assistance Payments Program
14.249	Section 8 Moderate Rehabilitation Single Room Occupancy
14.856	Lower Income Housing Assistance Program—Section 8 Moderate Rehabilitation

Programs *Not* Included in the Compliance Supplement. Some of the HUD-assisted multifamily programs are not included in the Compliance Supplement. As discussed above, when a federal program subject to compliance testing is not included in the Compliance Supplement, 2 CFR section 200.514(d)(3) requires the auditor to use the 12 types of compliance requirements as guidance for determining the compliance requirements to test and to determine the appropriate requirements based upon a review of the terms and conditions of the federal award and federal statutes and regulations referred to in the award. Part 7 of the Compliance Supplement provides detailed guidance on identifying the compliance requirements and designing compliance tests for programs not included in the Compliance Supplement.

Part 7 of the Compliance Supplement states that one of the steps for determining compliance requirements is to refer to federal agency audit guides. Therefore, for HUD multifamily programs not included in Parts 2 and 4 of the Compliance Supplement, auditors should refer to the compliance audit procedures in Chapter 3 of the HUD audit guide (HUD Handbook 2000.04 REV-2, CHG-7). In all cases, auditors should read the individual regulatory agreements, HAP contracts, and other award documentation to ensure that no other material compliance provisions exist.

Major versus Nonmajor Program Testing

The Uniform Guidance, at 2 CFR section 200.514(d), requires the auditor to perform transaction tests and other audit procedures necessary to determine that the recipient complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each of its major programs. No testing is required for nonmajor programs.

Auditor's Reports

An in-depth discussion of the auditor's reporting responsibilities in a Single Audit is beyond the scope of this course, but more information is available in *PPC's Guide to HUD Audits*.

Financial Statements and Schedules

The Uniform Guidance identifies preparation of financial statements and schedules as an auditee responsibility. The Uniform Guidance, at sections 200.510 and 200.511, require the entity to prepare the following financial statements and schedules:

- *Financial Statements.* The financial statements must encompass the recipient (for example, the nonprofit entity) and fiscal year subject to audit.
- *Schedule of Expenditures of Federal Awards.* The schedule must include all federal awards expended during the audit period. Minimum requirements for the schedule are included in Exhibit 3-3. An illustrative example of a schedule of expenditures of federal awards is presented at Exhibit 3-4.
- *Summary Schedule of Prior Audit Findings.* The summary schedule of prior audit findings must report the status of all findings included in the prior audit's schedule of findings and questioned costs.
- *Corrective Action Plan.* As part of following up on audit findings, 2 CFR section 200.511(c) requires the auditee to prepare a corrective action plan to address each audit finding included in the schedule of findings and questioned costs (which is by reference part of the auditor's reports).

Exhibit 3-3

Minimum Requirements for the Schedule of Expenditures of Federal Awards—Nonprofit Audits

- The period covered by the schedule must be the same as those covered by the financial statements.
- Total federal awards expended.
- The federal programs listed individually by federal agency.
- Total federal awards expended for each individual federal program.
- Total federal awards expended for each cluster of programs.
- For research and development clusters, federal awards expended either by individual award or by federal agency and major subdivision within the agency.
- The *Assistance Listing* numbers or other identifying number when an Assistance Listing number is not available.
- For federal awards received by a subrecipient, the name of the pass-through entity and the identifying number assigned by the pass-through entity.
- Total amount provided to subrecipients from each federal program.
- Total amount of federal awards expended for loan or loan guarantee programs, including the value of new loans made during the period, the beginning balance of loans from previous years for which the federal government imposes continuing compliance requirements, and any interest subsidy, cash or administrative cost allowance.
- The value of federal awards expended in the form of noncash assistance, such as food commodities, insurance, and free rent.
- Note(s) describing the following:
  - Significant accounting policies used in preparing the schedule.
  - Whether the entity did or did not elect to use the 10 percent *de minimis* indirect cost rate.
  - Balances of loans and loan guarantee programs outstanding at the end of the audit period for loans described in 2 CFR section 200.502(b).

In addition, Appendix VII of the 2022 Compliance Supplement states that to maximize the transparency and accountability of COVID-19 related awards, they should be separately identified on the SEFA, accomplished by segregating each COVID-19 related award on a separate line with "COVID-19" as a prefix to the program name. If both COVID-19 related and non-COVID-19 related awards are expended under the same Assistance Listing number, a total for all expenditures under the program would also be required.

Exhibit 3-4

Schedule of Expenditures of Federal Awards Illustrating Minimum Requirements—Nonprofit Audits

XYZ CORPORATION
SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS[a, b]
FOR THE YEAR ENDED JUNE 30, 20X1

Federal Grantor/Pass-through Grantor/Program or Cluster Title	Federal Assistance Listing Number[c]	Pass-through Entity Identifying Number[d]	Total Federal Expenditures
U.S. Department of Housing and Urban Development direct programs:			
Section 202 Direct Loan	XX.XXX	—	$ 1,230,500
Section 8 Housing Assistance Payments	XX.XXX	—	223,000
Total expenditures of federal awards			$ 1,453,500

See accompanying notes to schedule of expenditures of federal awards.

XYZ CORPORATION
NOTES TO SCHEDULE OF EXPENDITURES OF FEDERAL AWARDS
FOR THE YEAR ENDED JUNE 30, 20X1

NOTE A—BASIS OF PRESENTATION[e]

The accompanying schedule of expenditures of federal awards includes the federal award activity of XYZ Corporation and is presented on the accrual basis of accounting. The information in this schedule is presented in accordance with the requirements of Title 2 U.S. *Code of Federal Regulations* Part 200, *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). Because the Schedule presents only a selected portion of the operations of XYZ Corporation, it is not intended to and does not present the financial position, changes in net assets, or cash flows of XYZ Corporation.

NOTE B—SUMMARY OF SIGNIFICANT ACCOUNTING POLICIES

Expenditures reported on the Schedule are reported on the accrual basis of accounting. Such expenditures are recognized following the cost principles contained in the Uniform Guidance, wherein certain types of expenditures are not allowable or are limited as to reimbursement. XYZ Corporation has elected not to use the 10 percent de minimis indirect cost rate as allowed under the Uniform Guidance.

NOTE C—U.S. Department of Housing and Urban Development Loan Program

XYZ Corporation has received a U.S. Department of Housing and Urban Development direct loan under Section 202 of the National Housing Act. The loan balance outstanding at the beginning of the year is included in the federal expenditures presented in the Schedule. XYZ Corporation received no additional loans during the year. The balance of the loan outstanding at June 30, 20X1 consists of:

Assistance Listing Number	Program Name	Outstanding Balance at December 31, 20X2
XX.XXX	Section 202 Direct Loan	$ 1,215,900

Notes:

[a] This illustrative example of the Schedule of Expenditures of Federal Awards is based on the appendix to Chapter 7 of the GAS/SA Audit Guide. The auditor may wish to use a practice aid to (1) assist in determining whether the SEFA includes the required elements and is accurate and complete and (2) appropriately document the auditor's procedures relating to the SEFA. Procedures should be responsive to the assertions of completeness, occurrence, accuracy, cutoff, and classification and understandability. The audit program should be tailored to the specific facts and circumstances and risk assessment of the engagement.

[b] To meet state or other requirements, an auditee may include nonfederal awards. If nonfederal awards are included, they are required to be segregated and clearly designated as nonfederal. Totals for federal awards must be shown separately, and exclude nonfederal amounts. The title of the schedule should be modified to indicate that nonfederal awards are included, and the auditor's reporting on the schedule should reference the correct title. As an alternative method, nonfederal awards may be included in a separate schedule.

[c] If the Assistance Listing number is not available, the auditee must indicate that the Assistance Listing number is not available and include in the schedule the program's name and, if available, other identifying number.

[d] If pass-through awards are received, the identifying number assigned by the pass-through entity must be included in the schedule. This column may be deleted if there are no pass-through awards.

[e] This note meets the Uniform Guidance requirement to disclose the significant accounting policies used in preparing the schedule.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

23. At the completion of a Single Audit, which of the following is submitted to an OMB-designated federal clearinghouse as part of the Single Audit reporting package?

    a. The data collection form.

    b. Unaudited financial statements.

    c. A summary schedule of audit findings in the current year.

    d. A schedule of findings and questioned costs.

24. Which of the following statements best describes a special consideration that may apply when auditing a nonprofit HUD-assisted entity?

    a. The auditor is responsible for preparing the schedule of prior audit findings and the corrective action plan.

    b. The auditor is required to perform tests on nonmajor programs to determine the client's compliance with federal statutes.

    c. If a program is not included in the Compliance Supplement, the auditor is not required to test it for compliance.

    d. Additional programs are audited as major until 20% of total federal awards are expended if the client is considered low risk.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

23. At the completion of a Single Audit, which of the following is submitted to an OMB-designated federal clearinghouse as part of the Single Audit reporting package? **(Page 231)**

    a. The data collection form. [This answer is incorrect. To streamline the distribution of audit reports and improve the government-wide collection and analysis of Single Audit results, the Uniform Guidance provides for a form, referred to as the *data collection form,* to be prepared at the completion of each Single Audit and submitted to the federal clearinghouse designated by the OMB. It is submitted *along with* a Single Audit reporting package; it is not *part of* the Single Audit reporting package.]

    b. Unaudited financial statements. [This answer is incorrect. Financial statements are included as part of the Single Audit reporting packages; however, they should be audited. Unaudited financial statements should *not* be submitted to the Federal Audit Clearinghouse.]

    c. A summary schedule of audit findings in the current year. [This answer is incorrect. Audit findings in the current year are not outlined in a summary schedule. However, the Single Audit reporting package should include a summary schedule of *prior* audit findings.]

    d. **A schedule of findings and questioned costs. [This answer is correct. The Single Audit reporting package typically includes five items, one of which is the auditor's reports, including the schedule of findings and questioned costs. The Single Audit reporting package should also include, among other things, the schedule of expenditures of federal awards (SEFA), presented as supplementary information to the basic financial statements.]**

24. Which of the following statements best describes a special consideration that may apply when auditing a nonprofit HUD-assisted entity? **(Page 232)**

    a. The auditor is responsible for preparing the schedule of prior audit findings and the corrective action plan. [This answer is incorrect. The Uniform Guidance, at sections 200.510 and 200.511, lists requirements for the entity (not the auditor) to prepare the financial statements and certain schedules. The summary schedule of prior audit findings and the auditee's corrective action plan are both included on this list.]

    b. The auditor is required to perform tests on nonmajor programs to determine the client's compliance with federal statutes. [This answer is incorrect. The Uniform Guidance, at 2 CFR section 200.514(d), requires the auditor to perform transaction tests and other audit procedures necessary to determine that the recipient complied with federal statutes, regulations, and the terms and conditions of federal awards that may have a direct and material effect on each of its major programs. *No* testing is required for nonmajor programs.]

    c. If a program is not included in the Compliance Supplement, a HUD auditor is not required to test it for compliance. [This answer is incorrect. Some of the HUD-assisted multifamily programs are not included in the Compliance Supplement. When a federal program subject to compliance testing is not included in the Compliance Supplement, 2 CFR section 200.514(d)(3) requires the auditor to use the 12 types of compliance requirements as guidance for determining the compliance requirements to test and to determine the appropriate requirements based upon a review of the terms and conditions of the federal award and federal statutes and regulations referred to in the award. Part 7 of the Compliance Supplement provides detailed guidance on identifying the compliance requirements and designing compliance tests for programs not included in the Compliance Supplement.]

d. **Additional programs are audited as major until 20% of total federal awards are expended if the client is considered low risk. [This answer is correct. In determining major programs, additional programs must be audited as major until at least 40% of total federal awards expended are classified as major programs. However, this percentage can be reduced to 20% for entities that qualify as "low-risk auditees" based on the criteria specified in 2 CFR section 200.520.]**

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to HUD Audits—Course 2—Compliance Auditing (HUDTG222)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to those questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, fax, or mail your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet**, **Self-study Course Evaluation**, and payment via one of the following methods:

   - Email to *CPLGrading@thomsonreuters.com*
   - Fax to **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     HUDTG222 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four

courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2023**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to HUD Audits—Course 2—Compliance Auditing (HUDTG222)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. What term provided in the authoritative guidance describes the way a government achieves its objectives?

   a. Compliance audit.

   b. Compliance requirement.

   c. Government program.

   d. Governmental audit requirement.

2. AU-C 935 cites which of the following as a framework for determining applicable compliance requirements?

   a. The governing board's meeting minutes.

   b. The rules and provisions of contract and grant agreements.

   c. HUD Housing Notice H 2013-23.

   d. The *OMB Compliance Supplement*.

3. What is a HUD compliance auditor's responsibility for noncompliance that occurs after the period covered by the auditor's report?

   a. The auditor must perform procedures until the report release date to ensure no noncompliance exists.

   b. If the auditor becomes aware of any noncompliance before the report release date, he or she should discuss it with management and those charged with governance if needed to keep the report from being misleading.

   c. If management or those charged with governance bring noncompliance issues to the auditor prior to the report release date, he or she should perform procedures to determine the extent and update the auditor's report.

   d. The auditor is required to cease plans for any future engagements with the entity and insist that the entity engage a different auditor.

4. Which of the following statements best describes an aspect of the reporting requirements for a compliance audit as outlined in the professional guidance?

   a. The auditor's opinion should be made at the level specified by the governmental audit requirement.

   b. The auditor's opinion will be based solely on all known and likely questioned costs and related requirements.

   c. The auditor's report on compliance must be issued separately from the report on internal control over compliance.

   d. For-profit and nonprofit HUD entities have the same reporting requirements under the professional guidance.

5. According to the HUD audit guide, a for-profit entity's HUD program is considered major if it does which of the following?
   a. Expends less than $500,000 in a year.
   b. Expends more than $500,000 in a year.
   c. Meets certain risk-based requirements outlined in the OMB's Uniform Guidance.
   d. Submits GAAP-basis financial statements to the HUD's Real Estate Assessment Center (REAC).
6. What entity is responsible for promoting the integrity, efficiency, and effectiveness of HUD programs?
   a. The AICPA Peer Review Board.
   b. The AICPA Professional Ethics division.
   c. The HUD Office of Inspector General (HUD OIG).
   d. The Office of Management and Budget (OMB).
7. If a HUD-assisted project is in a nonsurplus cash position or in default, which of the following could be considered equity skimming?
   a. Paying market value for services and supplies.
   b. Purchasing equipment that will be used for the project.
   c. Interest payments made with HUD approval.
   d. Cash disbursements or withdrawals.
8. According to Paragraph 6.24 of the Yellow Book, requesting staff to perform personal errands for a supervisor represents an example of what?
   a. Abuse.
   b. Fraud.
   c. Noncompliance.
   d. Waste.
9. According to the Yellow Book, an auditor's threshold for reporting fraud and noncompliance with laws and regulations is—
   a. the same as it is for reporting noncompliance with contracts and grant agreements.
   b. stricter than it is for reporting noncompliance with contracts and grant agreements.
   c. more relaxed that it is for reporting noncompliance with contracts and grant agreements.
   d. more important than it is for reporting noncompliance with contracts and grant agreements.
10. According to the Yellow Book, auditors should report management's failure to report findings of fraud or noncompliance as required directly to whom?
    a. The HUD OIG.
    b. A different member of management.
    c. Those charged with governance.
    d. Outside parties.

11. According to the HUD audit guide and the OMB's Uniform Guidance, HUD compliance auditors should test compliance with laws and regulations that could have a material effect on which of the following (most specifically)?

    a. The overall HUD entity.

    b. Each of the entity's minor federal award programs.

    c. Each of the entity's major federal award programs.

    d. Major and minor federal award programs.

12. When an auditor identifies instances of noncompliance with transaction-related requirements while performing tests of transactions, the auditor should report these transactions as which of the following?

    a. Abuse.

    b. Allowable costs.

    c. Equity skimming.

    d. Questioned costs.

13. In a HUD compliance audit, who has the responsibility for identifying government programs and complying with the compliance requirements for those programs?

    a. Management.

    b. The auditor.

    c. Those charged with governance.

    d. The HUD OIG.

14. The Home Investments Partnership Program (HOME Program) is an example of what?

    a. A HUD handbook that assists with day-to-day project operations.

    b. A source of funding other than HUD.

    c. A type of Housing Assistance Payments Contract (HAP contract).

    d. A program that provides "implementing regulations" for HUD projects.

15. What is the biggest difference between the auditor's consideration of internal control in a HUD audit and a financial statement audit?

    a. The way risks are assessed.

    b. How to obtain an understanding of internal control.

    c. The methods used to test controls.

    d. A focus on compliance with laws, contracts, and grant agreements.

16. Which of the following statements best describes how auditors determine what controls to test in a HUD compliance audit?

    a. Auditors are required to test internal control over compliance for all activities, even if not related to major programs.

    b. If the effects of controls are excluded based on risk assessment, auditors can make the audit more efficient by not testing those controls.

    c. Auditors should document and plan tests of controls to support the assessed level of control risk of noncompliance for major programs.

    d. If internal control over compliance is determined ineffective, the auditor is required to plan and perform additional tests on the affected compliance requirements.

17. Are auditors allowed to use the results of prior years' tests of compliance controls?

    a. Yes, authoritative literature requires auditors to use prior years' results for the current year.

    b. Yes, although not required, prior years' results can provide important information for auditors to consider.

    c. No, prior years' results are typically considered to be ineffective and must not be used.

    d. No, using prior years' results requires auditors to report a significant deficiency in internal control over compliance.

18. When performing tests of compliance, when might an auditor test 100% of the items available?

    a. Individually important items make up the entire population.

    b. There is not an acceptably low risk of material noncompliance.

    c. The population does not include individually significant items.

    d. Certain items in the population are significantly different from the rest.

19. According to Chapter 3 of the HUD audit guide, which of the following would likely be tested using audit sampling when auditing a for-profit HUD-assisted entity?

    a. Residual receipts, equity skimming, and the Mark-to-Market (M2M) program.

    b. Residual receipts, tenant security deposits, and the M2M program.

    c. Equity skimming, tenant security deposits, and excess income.

    d. Tenant security deposits, excess income, and management functions.

20. A minimum group project-based sample for compliance testing should be the greater of 20% of the entities in the population or how many HUD-assisted entities?

    a. Two.

    b. Four.

    c. Six.

    d. Ten.

21. Chapter 2 of the HUD audit guide eliminated the requirement for a compliance auditor to do which of the following?
    a. Report on nonmajor HUD programs.
    b. Use group project-based sampling.
    c. Test compliance with the fair housing and nondiscrimination requirements.
    d. Consider the Yellow Book's requirements about material noncompliance.
22. When might project owners need to file Form HUD-92547-A, "Budget Worksheet"?
    a. They use "actual vs. budget" operating comparisons for the past quarter.
    b. Their projects would be considered financially troubled.
    c. They are needed as part of the monthly accounting reports.
    d. They use a budget based approach to apply for a rent increase.
23. According to the HUD Handbook, the written screening criteria for applicants *must* prohibit applicants with which of the following?
    a. Poor credit history.
    b. Drug-related behavior.
    c. Minimum income requirements.
    d. Unhealthy housekeeping habits.
24. Which of the following is one of the entity's responsibilities for disabled persons under Section 504 of the Rehabilitation Act of 1973 and the Fair Housing Act (FH Act)?
    a. Make all requested structural modifications to a disabled person's unit.
    b. Request that affected tenants provide their own communication aids.
    c. Allow tenants to have and use service animals for necessary assistance.
    d. Hire an outside entity to perform an annual evaluation of disability discrimination.
25. When testing a for-profit HUD-assisted project's compliance with its mortgage status, the auditor should determine which of the following if the entity has a mortgage assigned to HUD?
    a. The owner uses excess cash to make additional, unplanned improvements to the project.
    b. The owner pays all the costs for reasonable and necessary restoration and upgrades to the project.
    c. The project makes distributions of profits to owners once per year, at a minimum.
    d. The project makes at least one payment per year on principal or interest that is junior to the HUD mortgage.
26. Residual receipts would include which of the following?
    a. Surplus cash for nonprofit projects.
    b. BMIR contract rent.
    c. Distributions of cash to partners.
    d. Management fees paid to a general partner.

27. Maria is engaged to audit a for-profit HUD-assisted entity. While performing her audit, Maria discovers that HUD-assisted funds were used to pay for another project's maintenance and administrative expenses. This is an example of which of the following?

    a. Cash receipts.

    b. Equity skimming.

    c. A replacement reserve.

    d. Unauthorized loans.

28. Which of the following statements would best help a HUD auditor evaluate noncompliance?

    a. Immaterial instances of noncompliance do not need to be considered in the aggregate in a HUD audit.

    b. Noncompliance that is material to one major program is likely to be material to all major programs.

    c. Materiality for a specific major program is likely to stay the same in subsequent audits.

    d. A material issue of noncompliance exists if the failure to comply is material to a federal program.

29. In compliance auditing, what is the distinction between an opinion and a report?

    a. An opinion requires a scope of work sufficient enough to provide a reasonable basis, whereas a report merely states findings based of a scope of work provided for another purpose.

    b. An opinion simply describes the results of compliance tests performed as part of a financial statement audit, whereas a report typically requires more expanded testing to provide adequate assurance.

    c. An opinion requires a certain scope of tests and findings, as outlined in the Yellow Book, whereas a report merely describes instances of noncompliance.

    d. An auditor is required to form an opinion as specified by the governmental audit requirement, but the report may be optional under certain circumstances.

30. Which of the following statements best describes an aspect of how questioned costs affect the auditor's opinion on major program compliance?

    a. Total questioned costs for each major program must be determined exactly, not estimated.

    b. If no questioned costs will result from material noncompliance, the auditor does not need to consider it.

    c. Likely questioned costs are usually extrapolated from the audit evidence obtained by the auditor.

    d. Nonmaterial instances of noncompliance can be reported to management orally if no questioned costs are associated.

31. Why might noncompliance with compliance requirements that result in questioned costs have a material effect on a HUD-assisted entity's financial statements?

    a. Questioned costs might not be reimbursed, or they might have to be refunded

    b. There is a lower associated materiality level with questioned costs and related compliance requirements.

    c. If questioned costs occur, they are automatically considered material to the financial statements.

    d. The entity would never record a liability for questioned costs in the financial statements.

32. The HUD audit guide instructs auditors to follow the communication guidelines from which of the following if they discover fraud or possible fraud?

    a. AU-C 935.

    b. The GAS/SA Audit Guide.

    c. The HUD Handbook.

    d. The Yellow Book.

33. Which of the following statements about the use of audit sampling in tests of internal control over compliance is true?

    a. Auditors are required to use sampling when performing tests of controls in a compliance audit.

    b. Using audit sampling is a best practice when performing tests of controls with proper operation documentation.

    c. Inspection of documents is typically unnecessary when using audit sampling in tests of controls.

    d. It is most efficient to break down the population for the audit sample by each major program.

34. Typically, audit sampling would not be considered efficient if the expected rate of deviation from a particular control is more than how much, at a minimum, of the tolerable deviation rate?

    a. One third.

    b. One half.

    c. Two thirds.

    d. Three fourths.

35. When using audit sampling to test internal control over compliance, dividing the number of observed deviations by the total sample size provides what?

    a. The deviation rate.

    b. The expected exception rate.

    c. Planning materiality.

    d. The tolerable exception rate.

36. When testing compliance with laws and regulations in accordance with the HUD audit guide, what sampling method is appropriate?

    a. Attribute sampling.

    b. Block sampling.

    c. Group project-based sampling.

    d. Nonstatistical sampling.

37. Jenna is engaged to test a for-profit HUD-assisted project's compliance with laws and regulations, and she plans to use audit sampling. The population available to test has less than 250 items. A sample size of what percentage would typically be appropriate?

    a. 10%.

    b. 20%.

    c. 30%.

    d. 50%.

38. Which of the following forms has the Uniform Guidance provided to help streamline distribution of audit reports and improve analysis of Single Audit results?

    a. The monthly report of excess income.

    b. The data collection form.

    c. The schedule of disbursements.

    d. The quarterly performance report.

39. The risk-based approach recommended in 2 CFR 200.518 used to determine which federal programs are major programs focuses on which of the following?

    a. The amount of dollars expended.

    b. The risk of the occurrence of noncompliance.

    c. The results of prior-year tests of controls.

    d. Compliance requirements found in the Compliance Supplement.

40. Which of the following is one of the minimum requirements for the schedule of expenditures of federal awards (SEFA) in a nonprofit audit?

    a. The period covered must be within six months of the financial statement period.

    b. A note that no subrecipients received federal awards provided to the entity.

    c. A note describing the balance of loan guarantee programs outstanding each month.

    d. Total federal awards expended for each one of the entity's federal award programs.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to HUD Audits—Course 2—Compliance Auditing (HUDTG222)

Name: ______________________________

Firm Name: ______________________________

Firm Address: ______________________________

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Firm Phone: ______________________ Firm Fax No.: ______________

Firm Email: ______________________________

Signature: ______________________________

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Birth Month: ______________________ Licensing State: ______________

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	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	11.	○	○	○	○	21.	○	○	○	○	31.	○	○	○	○
2.	○	○	○	○	12.	○	○	○	○	22.	○	○	○	○	32.	○	○	○	○
3.	○	○	○	○	13.	○	○	○	○	23.	○	○	○	○	33.	○	○	○	○
4.	○	○	○	○	14.	○	○	○	○	24.	○	○	○	○	34.	○	○	○	○
5.	○	○	○	○	15.	○	○	○	○	25.	○	○	○	○	35.	○	○	○	○
6.	○	○	○	○	16.	○	○	○	○	26.	○	○	○	○	36.	○	○	○	○
7.	○	○	○	○	17.	○	○	○	○	27.	○	○	○	○	37.	○	○	○	○
8.	○	○	○	○	18.	○	○	○	○	28.	○	○	○	○	38.	○	○	○	○
9.	○	○	○	○	19.	○	○	○	○	29.	○	○	○	○	39.	○	○	○	○
10.	○	○	○	○	20.	○	○	○	○	30.	○	○	○	○	40.	○	○	○	○

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Please indicate your answers by filling in the appropriate circle as shown:
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3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
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GLOSSARY

Abuse: According to the Yellow Book, abuse involves behavior that is deficient or improper when compared with behavior that a prudent person would consider reasonable and necessary business practice given the facts and circumstances. It includes the misuse of authority or position for personal financial interests or those of an immediate or close family member or business associate.

Applicable compliance requirements: The *compliance requirements* that are subject to the *compliance audit*.

Audit risk of noncompliance: The risk that the auditor expresses an inappropriate audit opinion on compliance when *material noncompliance* exists. This risk is a function of the risks of material noncompliance and the detection risk of noncompliance.

Compliance audit: A *program-specific audit* or an *organization-wide audit* of an entity's compliance with applicable *compliance requirements*.

Compliance requirements: Laws, regulations, rules, and provisions of contracts or grant agreements applicable to government programs that require compliance by an entity.

Deficiency in design: A control necessary to meet the control objective is missing or an existing control is not properly designed so that, even if it operates as designed, the control objective would not be met.

Deficiency in internal control over compliance: This exists when the design or operation of a control over compliance does not allow management or employees, in the normal course of performing their assigned functions, to prevent, or detect and correct, noncompliance on a timely basis. It can be a *deficiency in design* or a *deficiency in operation*.

Deficiency in operation: A properly designed control does not operate as designed or the person performing the control does not have the necessary authority or competence to perform it effectively.

Detection risk of noncompliance: The risk that the procedures performed by the auditor to reduce *audit risk of noncompliance* to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated, with other instances of noncompliance.

Exception: Departure from laws, regulations, and the provisions of contracts or grant agreements being tested.

Expected exception rate: The rate of *exceptions* the auditor expects in the population.

Governmental audit requirement: A government requirement established by law, regulation, rule, or provision of contracts or grant agreements that an entity obtain an audit of its compliance with applicable *compliance requirements* of government programs.

Government program: The means by which a government achieves its objectives (e.g., the National School Lunch Program). Those relevant for *compliance audit* purposes are those where a grantor or pass-through entity provides an award to another entity, usually in the form of a grant, contract, or other agreement.

Individually significant items: Those that, standing alone, are significantly different from the rest of the population, for example, increased activity around a certain time period, such as journal entries made at the beginning or end of the year.

Mark-to-Market Restructuring Program (M2M): This program allows an entity to address the situation if its Section 8 rent subsidy contract sets rents at a level that exceeds those charged for unregulated and unsubsidized housing of similar quality and location. It allows HUD to adjust the contract rents and restructure the entity's mortgage debt.

Material noncompliance: A failure to follow compliance requirements or a violation of prohibitions included in the applicable *compliance requirements* that result in noncompliance that is quantitatively or qualitatively material, either individually or when aggregated with other noncompliance, to the affected *government program*.

Material weakness in internal control over compliance: A deficiency, or combination of deficiencies, in internal control over compliance, such that there is a reasonable possibility that material noncompliance with a compliance requirement will not be prevented, or detected and corrected, on a timely basis. A reasonable possibility exists when the likelihood of an event occurring is either reasonably possible or probable.

Organization-wide audit: An audit entity's financial statements and an audit of its compliance with the applicable *compliance requirements* as they relate to one or more government programs that the entity administers.

Program-specific audit: An audit of an entity's compliance with applicable *compliance requirements* as they related to one *government program* that the entity administers. The *compliance audit* portion of a program-specific audit is performed in conjunction with an audit of either the entity's financial statements or the program's financial statements.

Questioned costs: Costs that are questioned by the auditor because they (1) violate (or possibly violate) the applicable *compliance requirements,* (2) are not supported by adequate documentation, or (3) appear unreasonable and do not reflect the actions of a prudent person under the circumstances.

Risk of material noncompliance: The risk that *material noncompliance* exists prior to the audit. This consists of the inherent risk of noncompliance and the control risk of noncompliance.

Significant deficiency in internal control over compliance: A deficiency, or combination of deficiencies, in internal control over compliance that is less severe than a *material weakness in internal control over compliance,* yet important enough to merit attention by those charged with governance.

Tolerable deviation rate: The maximum rate of deviation from a prescribed control that the auditor is willing to accept without altering the planned assessed level of control risk of noncompliance.

Tolerable exception rate: The maximum rate of compliance *exceptions* the auditor is willing to accept.

Waste: According to the Yellow Book, this is the act of using or expending resources carelessly, extravagantly, or to no purpose. It can include activities that do not include *abuse* and does not necessarily involve a violation of law. It primarily relates to mismanagement, inappropriate actions, and inadequate oversight.

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COMPANION TO PPC'S GUIDE TO HUD AUDITS

COURSE 3

PRE-ENGAGEMENT ACTIVITIES AND AUDIT PLANNING (HUDTG223)

OVERVIEW

COURSE DESCRIPTION:	This interactive self-study course looks at the pre-engagement activities and planning necessary for practitioners engaged to audit a project sponsored by the U.S. Department of Housing and Urban Development (HUD).
PUBLICATION/ REVISION DATE:	November 2022
RECOMMENDED FOR:	Users of *PPC's Guide to HUD Audits*
PREREQUISITE/ ADVANCE PREPARATION:	Basic knowledge of governmental auditing
CPE CREDIT:	9 NASBA Registry "QAS Self-Study" Hours This course is designed to meet the requirements of the *Statement on Standards of Continuing Professional Education (CPE) Programs* (the *Standards*), issued jointly by NASBA and the AICPA. As of this date, not all boards of public accountancy have adopted the *Standards* in their entirety. For states that have adopted the *Standards*, credit hours are measured in 50-minute contact hours. Some states, however, may still require 100-minute contact hours for self study. Your state licensing board has final authority on acceptance of NASBA Registry QAS self-study credit hours. Check with your state board of accountancy to confirm acceptability of NASBA QAS self-study credit hours. Alternatively, you may visit the NASBA website at **www.nasbaregistry.org** for a listing of states that accept NASBA QAS self-study credit hours and that have adopted the *Standards*. **Yellow Book CPE Credit:** This course is designed to assist auditors in meeting the continuing education requirements included in GAO's *Government Auditing Standards*.
FIELD OF STUDY:	Auditing (Governmental)
EXPIRATION DATE:	Postmark by **November 30, 2023**
KNOWLEDGE LEVEL:	Basic

Learning Objectives:

Lesson 1—Auditor Responsibilities and Requirements, Client Acceptance and Continuance, Establishing the Terms of the Engagement, and Audit Planning

Completion of this lesson will enable you to:

- Identify authoritative literature and other auditor responsibilities and requirements that apply to HUD audits.
- Recognize best practices for client acceptance and continuance and establishing the terms of a HUD engagement.
- Determine what procedures HUD auditors should perform when planning a HUD audit.

Lesson 2—Obtaining an Understanding of the Entity, Its Environment, and Its Internal Control

Completion of this lesson will enable you to:
- Determine how auditors obtain an understanding of a HUD-assisted entity and its environment.
- Recognize how auditors obtain an understanding of a HUD-assisted entity's internal control.

Lesson 3—Audit Planning Decisions and Judgments, Sampling, Workpapers, Initial Engagements, and Group Financial Statements

Completion of this lesson will enable you to:
- Recognize the audit planning decisions and judgments a HUD auditor may need to make.
- Identify best practices for the use of audit sampling, detailed audit plans, and other workpapers in a HUD audit.
- Determine what additional procedures may be necessary in an initial HUD audit or an audit of group HUD financial statements.

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Lesson 1: Auditor Responsibilities and Requirements, Client Acceptance and Continuance, Establishing the Terms of the Engagement, and Audit Planning

INTRODUCTION

This course discusses the activities that should take place when deciding whether to propose for or accept a HUD-assisted project as a new client or to retain one as an existing client. It also discusses the necessary activities in the early planning stages of a new or continuing audit engagement.

Pre-engagement activities involve consideration of the auditor's ability and desire to propose for, accept, or retain a particular HUD-assisted project engagement, including the auditor's independence and technical expertise; management's integrity; and the scope of the audit. Pre-engagement activities also include communicating with the predecessor auditor, if there is one, and establishing the terms of the engagement.

Planning activities include obtaining an understanding of the entity and its environment, including HUD and government regulations and related audit requirements, the particular entity's activities, internal control, and factors, including fraud and violations of laws and regulations, that affect the risks of material misstatements in its financial statements and material noncompliance with applicable laws and regulations. These activities allow the auditor to make a decision about the acceptance or continuance of a client relationship, but certain pre-engagement activities also provide the auditor with important information that directly contributes to the assessment of risks and development of an audit strategy and detailed audit plan.

Much of PPC's guidance on generally accepted auditing standards is consolidated in *PPC's Guide to Audits of Nonpublic Companies*. This course tailors it specifically to address the unique issues, circumstances, and audit approaches common to audits of HUD-assisted projects. The checklists, confirmation letters, and audit programs found in *PPC's Guide to Audits of Nonpublic Companies* have been tailored for audits of HUD-assisted entities and are available in *PPC's Guide to HUD Audits*.

Government Auditing Standards (the Yellow Book) and the *Consolidated Audit Guide for Audits of HUD Programs* (HUD Handbook 2000.04, REV-2; the HUD audit guide) also provide guidance about pre-engagement and planning activities that should be considered in HUD audits.

Learning Objectives:

Completion of this lesson will enable you to:

- Identify authoritative literature and other auditor responsibilities and requirements that apply to HUD audits.
- Recognize best practices for client acceptance and continuance and establishing the terms of a HUD engagement.
- Determine what procedures HUD auditors should perform when planning a HUD audit.

Authoritative Literature

The authoritative literature that establishes requirements or provides guidance about the audit considerations that occur in the pre-engagement and planning stages of an engagement are as follows:

- AU-C 210A, *Terms of Engagement*, establishes the auditor's responsibilities in agreeing upon the terms of the audit engagement with management and, when appropriate, those charged with governance. This includes determining that certain preconditions for an audit, for which management and, when appropriate, those charged with governance are responsible, are present.

- AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, establishes specific quality control requirements to be performed as part of an audit.
- AU-C 230, *Audit Documentation*, addresses the auditor's responsibility to prepare audit documentation for an audit of financial statements. These requirements apply to documentation of risk assessment procedures as well as to all other audit procedures.
- AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, establishes requirements for identifying and assessing the risks of material misstatement due to fraud and determining the overall and specific responses to those risks.
- AU-C 250, *Consideration of Laws and Regulations in an Audit of Financial Statements*, establishes requirements for obtaining an understanding of the legal and regulatory framework relevant to the industry or sector in which the entity operates and how the entity complies with that framework.
- AU-C 260, *The Auditor's Communication With Those Charged With Governance*, establishes requirements for the auditor to communicate with those charged with governance.
- AU-C 300, *Planning an Audit*, establishes requirements for audit planning, including the preliminary engagement activities that the auditor should undertake at the beginning of the current audit, development of an overall strategy and audit plan, involvement of the engagement partner and team members, and consideration of whether specialized skills are needed.
- AU-C 315A, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*, establishes requirements for performing risk assessment procedures to provide a basis for identifying and assessing risks of material misstatement and requires obtaining an understanding of various specific matters, including the aspects of internal control relevant to the audit.
- AU-C 320, *Materiality in Planning and Performing an Audit*, establishes requirements for determining materiality for the financial statements as a whole and performance materiality for assessing the risks of material misstatement at the assertion level, and determining the nature, timing, and extent of further audit procedures.
- AU-C 330, *Performing Audit Procedures in Response to Assessed Risks and Evaluating the Audit Evidence Obtained*, establishes requirements for determining the nature, timing, and extent of further audit procedures (both tests of controls and substantive procedures) in response to the assessed risks of material misstatement.
- AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance on obtaining an understanding of internal control of a client that uses a service organization.
- AU-C 500, *Audit Evidence*, provides guidance regarding the use of management's specialists who have expertise in a field other than accounting or auditing.
- AU-C 510, *Opening Balances—Initial Audit Engagements, Including Reaudit Engagements*, provides guidance on the auditor's responsibilities relating to opening balances in an initial audit, including reaudit engagements.
- AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*, establishes requirements for considering whether conditions or events exist that raise substantial doubt about an entity's ability to continue as a going concern for a reasonable period of time.
- AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, provides guidance on the special considerations that apply to group audits, in particular those involving component auditors.

- AU-C 620A, *Using the Work of an Auditor's Specialist*, provides guidance on the use of a specialist that possesses expertise in an area other than accounting or auditing.
- AU-C 935, *Compliance Audits*, provides guidance on applying GAAS in a compliance audit, *Government Auditing Standards* requirements for financial audits, and a governmental audit requirement that requires an opinion on compliance.
- Statement on Quality Control Standards (SQCS) No. 8 (QM-10A), *A Firm's System of Quality Control*, describes the quality control policies and procedures, including those that pertain to client acceptance and continuance, that a member firm's quality control system should encompass
- AICPA *Code of Professional Conduct* (Code) provides the ethical framework for members in the performance of their professional responsibilities. The *Independence Rule* (ET 1.200.001) and related interpretations provide requirements and guidance regarding an auditor's independence in relationship to an attest client. Auditors also need to comply with other ethical requirements of the Code when considering whether an engagement can be accepted or continued.
- GAO *Government Auditing Standards, 2018 Revision Technical Update April 2021* (the Yellow Book).
- (For-profit audits) *Consolidated Audit Guide for Audits of HUD Programs* (HUD audit guide) issued by the HUD OIG.
- (Nonprofit audits) *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance) issued by the OMB.
- AICPA Audit Guide, *Government Auditing Standards and Single Audits*.

Applicability of AU-C 935. AU-C 935, *Compliance Audits*, applies when an auditor is engaged, or required by law or regulation, to perform a compliance audit in accordance with all of the following—

- Generally accepted auditing standards;
- *Government Auditing Standards* requirements for financial audits; and
- A governmental audit requirement that requires an opinion on compliance, as typically required in an engagement to audit a HUD-assisted entity.

AU-C 935 requires auditors to use professional judgment to adapt and apply GAAS to a compliance audit and provides guidance on how to do so. This does not mean the auditor has to literally translate every procedure applicable in a financial statement audit. Instead, the auditor should modify and apply the GAAS procedures considered relevant and necessary for obtaining sufficient appropriate audit evidence to support an opinion on compliance. Certain sections of GAAS can be adapted and applied to a compliance audit with relative ease. This might be done, for example, by replacing the word *misstatement* with the word *noncompliance*. However, other sections are more difficult to adapt and apply without further modification. Accordingly, AU-C 935 provides specific guidance on how to adapt certain AU-C sections to a compliance audit. This course discusses relevant considerations adapting and applying various AU-C sections in the context of a compliance audit when applicable. In August 2022, the AICPA issued SAS No. 148, *Amendment to AU-C Section 935*. SAS No. 148 amends AU-C 935 for implications from the issuances of SAS No. 142, *Audit Evidence*, and SAS No. 145, *Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement*. The amendments related to SAS No. 142 are effective for fiscal periods ending on or after December 15, 2022, consistent with the effective date of SAS No. 142. This edition of the course fully incorporates SAS No. 142. The amendments resulting from the issuance of SAS No. 145 are effective for compliance audits for fiscal periods ending on or after December 15, 2023, consistent with the effective date of SAS No. 145. Due to the delayed effective date, this edition of the course does not fully incorporate SAS No. 145. The aspects of AU-C 935 that specifically address pre-engagement and planning considerations for a compliance audit are discussed in this course.

Literature Specific to HUD Entities

HUD Audit Guide—For-profit Audits. In addition to GAAS and *Government Auditing Standards*, audits of for-profit HUD entities must comply with the *Consolidated Audit Guide for Audits of HUD Programs* (the HUD audit guide) issued by the HUD Office of Inspector General (HUD OIG). The requirements in Chapter 1 of the HUD audit guide that affect audit pre-engagement and planning activities in a HUD audit include:

- Specification of certain items to be included in the engagement letter.
- Specification of the values used for determining major programs.
- Additional communication requirements when the auditor withdraws or is terminated from the engagement.
- Guidance on new sampling requirements, including the use of attribute sampling, sample selection, minimum sample sizes, and the use of dual-purpose samples.

These and other HUD requirements are discussed where applicable throughout this course.

Other HUD Documents. Certain other HUD documents provide accounting, auditing, and reporting guidance that should be considered during pre-engagement and planning activities. For example:

- Handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, includes audit requirements and provides project accounting and reporting guidance.
- Housing Notice H 2013-23, "Change in Annual Financial Statement (AFS) Submission Requirements for Some Multifamily Housing Projects," exempts multifamily housing projects that receive less than $500,000 in combined federal financial assistance from the requirement to obtain an audit.

Some discussions in this course are directed to requirements in the HUD audit guide. These provisions only apply to for-profit entities. However, much of this course addresses the general nature of pre-engagement and audit planning activities and applies to audits of both for-profit and nonprofit HUD-assisted entities.

Uniform Guidance for Single Audits of Nonprofit HUD Entities

Nonprofit entities are included in the scope of the Single Audit Act and the OMB's *Uniform Administrative Requirements, Cost Principles, and Audit Requirements for Federal Awards* (Uniform Guidance). In addition, nonprofit HUD entities are directed by Paragraph 1-2 of the HUD audit guide to obtain an audit in accordance with OMB Circular A-133. OMB Circular A-133 has been superseded by OMB's Uniform Guidance at 2 CFR part 200, subpart F, however, OMB's responsibility to issue an annual *Compliance Supplement* (Compliance Supplement) has not changed. Chapter 1 of the HUD audit guide further explains auditors should normally use the Compliance Supplement, not the HUD audit guide, when auditing program compliance by nonprofit HUD-assisted entities. If a program is not included in the Compliance Supplement but is covered in the HUD audit guide, the auditor should use the compliance requirements and suggested audit procedures in the HUD audit guide along with the guidance in part 7 of the Compliance Supplement to develop an audit program.

The requirements of the Uniform Guidance that pertain to pre-engagement and planning activities are discussed where applicable throughout this course.

Applicability of the AICPA Audit Guide

The AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), presents guidance for financial statement audits performed under *Government Auditing Standards* in Part I. This guidance applies to all HUD audits, both for-profit and nonprofit audits. It provides guidance for compliance audits conducted under the Single Audit Act and the Uniform Guidance in Part II. Although the guidance in Part II only specifically applies to audits of HUD nonprofit entities performed in accordance with the Uniform Guidance, the authors believe that much of the general guidance in Part II for performing compliance audits ought to be considered in all HUD audits, and have incorporated it in this course where relevant. This course reflects guidance available in the April 2022 edition of the GAS/SA Audit Guide.

OTHER AUDITOR RESPONSIBILITIES AND PROFESSIONAL REQUIREMENTS

Categories of Professional Requirements

Both GAAS and *Government Auditing Standards* establish two specific categories of professional requirements to describe the degree of responsibility imposed on auditors:

- *Unconditional Requirements.* These requirements are identified by the words "must" or "is required." Auditors must follow unconditional requirements in all cases if the circumstances apply to the requirement.
- *Presumptively Mandatory Requirements.* These requirements are identified by the word "should." Auditors must also comply with presumptively mandatory requirements if the circumstances apply to the requirement. However, in rare situations, a departure from the requirement is allowed if the auditor documents the justification and how alternative procedures that were performed were sufficient to achieve the intent of the requirement.

The standards also contain related guidance in the form of application and other explanatory material that further explains the requirements and provides guidance for applying them. For example, it might explain more precisely what a requirement means or addresses, or might provide examples of appropriate audit procedures. Although this guidance does not impose requirements on the auditor, it is relevant to properly applying the requirements. Auditors should have an understanding of the application and other explanatory material. The words *may*, *might*, and *could* are used to describe these actions and procedures.

Quality Management

ASB's Quality Management Standards. In June 2022, the Auditing Standards Board issued the following three interrelated standards:

- Statement on Quality Management Standards No. 1, *A Firm's System of Quality Management* (SQMS No. 1).
- Statement on Quality Management Standards No. 2, *Engagement Quality Reviews* (SQMS No. 2).
- Statement on Auditing Standards (SAS) No. 146, *Quality Management for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards* (SAS No. 146).

  SQMS No. 1 supersedes SQCS No. 8, SQMS No. 2 provides the requirements for the appointment and eligibility of engagement quality reviewers and performance of engagement quality reviews, and SAS No. 146 supersedes AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*. Various other AU-C sections are also amended by the guidance. The ASB believes the quality management standards will improve the scalability of the standards and promote a quality management system that is more tailored to the firm and its engagements. Firms are required to design and implement systems of quality management in compliance with SQMS No. 1 by December 15, 2025, and to perform an evaluation of the system of quality management required by SQMS No. 1 within one year following December 15, 2025. SQMS No. 2 is effective for audits or reviews of financial statements for periods beginning on or after December 15, 2025. SQMS No. 2 is effective for the firm's other engagements in its accounting and auditing practice beginning on or after December 15, 2025. Some of the key changes of SQMS Nos. 1 and 2 are further discussed below.

SQMS No. 1 takes a new approach in addressing the firm's responsibility to design, implement, and operate a system of quality management for its accounting and auditing practice. The new approach is risk-based and designed to improve scalability of the standards by requiring a quality management system that is tailored to the nature and circumstances of the firm and its engagements. The new approach requires a firm to customize its system of quality management based on the nature and circumstances of the firm and its engagements using an approach that considers the quality management system as a whole, with a stronger focus on continual remediation and improvement. Under SQMS No. 1, the firm's system of quality management is comprised of eight components rather than the six quality control elements under SQCS No. 8. SQMS No. 1 adapts the existing six QC elements, renaming three of them, and adds two new components.

SQMS No. 2 deals with the appointment and eligibility of the engagement quality reviewer, and the requirements, performance, and documentation of the engagement quality review. The appointment and eligibility of the engagement quality reviewer requirements are more robust than under current SQCS No. 8. An eligible engagement quality control reviewer is not a member of the engagement team; thus the review allows for an objective evaluation of the significant judgments made by the engagement team and the conclusions reached thereon.

How PPC Guides Contribute to Audit Quality. If used properly based on the circumstances of the particular engagement, *PPC's Guide to HUD Audits* and its practice aids contribute to performing audits in accordance with professional standards. That *Guide* and this course have been updated for relevant professional standards, and, as noted in the introductory materials, the Tax and Accounting business of Thomson Reuters has voluntarily elected to undergo a peer review on an annual basis of its system for the development and maintenance of quality control materials

To help achieve an audit performed in accordance with professional standards, *PPC's Guide to HUD Audits* outlines an overall audit process. Also, the authors recommend that, in addition to a careful review of the professional standards, the practice aids, where applicable, be applied to the relevant circumstances of audit engagements. Practice aids in that *Guide* typically incorporate relevant professional standards (as well as best practices and practical guidance). If the auditor decides to use other methods to perform and document audit procedures for matters addressed by a practice aid, the authors suggest that the practice aid be carefully reviewed to ensure that relevant requirements are incorporated in the audit procedures and documentation. Also, the chapter material in that *Guide* should not be overlooked since it provides important *additional* guidance on professional standards, including other practical information, as well as how the practice aids may be applied to audit engagements. Of course, the auditor needs to apply professional judgement and skepticism, incorporate appropriate competence in the circumstances, and ensure due diligence throughout the audit process.

GAO Quality Control and Assurance Requirements. Paragraph 5.02 of the Yellow Book indicates that audit organizations conducting Yellow Book audits must establish and maintain a quality control system that is designed to provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements. The Yellow Book, Paragraph 5.84, requires an audit organization not already subject to a peer review requirement to obtain an external peer review at least once every three years. The audit organization should obtain its first peer review covering a review period ending no later than three years from the date an audit organization begins its first Yellow Book engagement (i.e., the start of field work).

According to Paragraph 5.79 of the Yellow Book, auditors entering into a contract to perform a Yellow Book engagement should provide their most recent external peer review report, and any subsequent peer review reports received during the period of the contract, when requested by the party contracting for the audit. The auditor should not only provide the appropriate information each time an engagement letter or contract is issued, but also when presenting proposals for Yellow Book engagements, if requested to do so.

The HUD audit guide does not require auditors to transmit their peer review reports unless they are requested. Paragraph 1-8 of the HUD audit guide reiterates that the Yellow Book requires audit organizations to obtain an external peer review at least once every three years. However, the peer review report does not have to be submitted to HUD or HUD OIG unless it is requested by representatives of those offices or specifically required by other chapters of the HUD audit guide.

The GAS/SA Audit Guide, Paragraph 2.65, indicates that auditors who are using another audit organization's work should request a copy of that organization's most recent peer review report and any other written communication issued. That other audit organization should provide the documents upon request.

<u>Requirement to Make Peer Review Report Publicly Available.</u> The Yellow Book, at Paragraph 5.77, states that external audit firms should make their most recent peer review report publicly available. This can be done, for example, by posting the peer review report on a publicly available internet site or to a publicly available site designed for transparency of peer review results. The GAS/SA Audit Guide, Paragraph 2.63, explains that if these options are not available, the audit firm should use the same transparency mechanism it uses to make other information public.

The audit organization also should provide the peer review report to others when requested. Any separate communication of findings, conclusions, and recommendations that may have been issued does not have to be made publicly available. *Government Auditing Standards*, Paragraph 5.81, provides additional information on transparency of peer review reports, including information that might be included with a publicly available report to help users understand its meaning.

Ethical Principles

Auditors need to comply with the ethical requirements of the AICPA's *Code of Professional Conduct* when considering whether an engagement can be accepted or continued, and when they are engaged to perform professional services. *Government Auditing Standards* also discusses the auditor's responsibility for ethical behavior. The Yellow Book, in Chapter 3, "Ethics, Independence, and Professional Judgment," provides the foundation, discipline, and structure, as well as the environment, that influence the application of *Government Auditing Standards*. Chapter 2 of the Yellow Book, "General Requirements for Complying with Government Auditing Standards," discusses the general requirements for complying with *Government Auditing Standards*

The Yellow Book, at Paragraph 3.03, emphasizes that the public expects auditors to follow ethical principles when performing work under *Government Auditing Standards*. According to Paragraph 3.04 of the Yellow Book:

> Ethical principles apply in preserving auditor independence, taking on only work that the audit organization is competent to perform, performing high-quality work, and following the applicable standards cited in the auditor's report.

The Yellow Book emphasizes that performing audit work in accordance with ethical principles is both an individual and an organizational responsibility. Paragraph 3.06 of the Yellow Book provides the following ethical principles that guide the work of auditors and audit organizations conducting audits in accordance with *Government Auditing Standards*:

- The public interest.
- Integrity.
- Objectivity.
- Proper use of government information, resources, and positions.
- Professional behavior.

Independence

The AICPA, state boards, the Securities and Exchange Commission, the PCAOB, HUD, and the Government Accountability Office (GAO) all have their own independence rules. *PPC's Guide to GAAS* provides a detailed discussion of the independence rules in the AICPA's *Code of Professional Conduct*. Auditors of HUD projects should be familiar and compliant with all applicable regulations regarding independence. An overview of major differences between the AICPA and Yellow Book independence requirements is provided below. AICPA independence requirements, Yellow Book independence requirements, and additional HUD independence requirements are all discussed in more detail later in this section.

AICPA and GAO Independence Standards—Major Differences. Major differences between the independence requirements in the AICPA's *Code of Professional Conduct* and the independence requirements in *Government Auditing Standards* relate to (a) when the conceptual framework for independence is used and (b) certain documentation requirements.

<u>When the Conceptual Framework Is Used.</u> Paragraph 2.36 of the GAS/SA Audit Guide states that the AICPA's *Code of Professional Conduct* and *Government Auditing Standards* have similar, but not identical, conceptual frameworks for independence. The Yellow Book's conceptual framework is used to evaluate threats to independence when making decisions on conditions or activities that are not specifically prohibited by *Government Auditing Standards*.

However, the AICPA's conceptual framework should be used when making decisions about independence matters that are not explicitly addressed in the *Code of Professional Conduct*.

While the conceptual frameworks do continue to have fairly similar characteristics, there are more significant differences in requirements in the Yellow Book relating to nonattest/nonaudit services, particularly related to preparation of accounting records and financial statements. The AICPA Code does not require auditors to consider preparation of accounting records and financial statement services as services that create threats or significant threats to independence, thereby triggering additional analysis and evaluation. While the Code may indicate that the services described in Paragraphs 3.88–.89 of the Yellow Book are permissible without the application of safeguards (if ET 1.295 is complied with), similar services not addressed in the Code would need to be evaluated under the AICPA Conceptual Framework.

<u>Documentation Requirements.</u> The Yellow Book contains specific documentation requirements, including the requirements and applicable guidance relating to independence in Paragraphs 3.107 and 3.108, respectively.

AICPA Independence Requirements. AU-C 200, *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance With Generally Accepted Auditing Standards*, requires the auditor to be independent, unless GAAS or law or regulation specifies otherwise. AICPA independence rules apply to engagements for attest clients, which are persons or entities with respect to which an attest engagement is performed. Some of the AICPA independence rules apply a team approach, which narrows the pool of those members of a firm who are subject to certain independence requirements by focusing on *covered members*. Covered members include those who are (a) members of an attest engagement team; (b) able to influence the engagement or attest engagement team; (c) a partner, partner equivalent, or manager who provides 10 or more hours of nonattest services to the attest client within any fiscal year; (d) a partner or partner equivalent in the office in which the lead attest engagement partner or partner equivalent primarily practices in connection with the attest engagement; (e) the firm, including the firm's employee benefit plans; and (f) an entity whose operating, financial, or accounting policies can be controlled by any of items (a) to (e) or two or more of them acting together (ET 0.400.12). By carefully considering the definition of a covered member, auditors may be able to structure the engagement team so that independence is not impaired. The AICPA's *Code of Professional Conduct* (ET 0.400.05) defines the *attest engagement team* as those individuals who participate in the attest engagement, including those individuals performing concurring and engagement quality reviews. The attest engagement team consists of employees and contractors retained by the firm who participate in the attest engagement regardless of their functional classification as audit, tax, management consulting services, or other function. Specialists as discussed in AU-C 620A, *Using the Work of an Auditor's Specialist*, and individuals performing only routine clerical functions are excluded from the attest engagement team. *PPC's Guide to GAAS* provides a detailed discussion of those and other independence rules. Conclusions on compliance with AICPA independence requirements applicable to the engagement, including the identification of any threats to independence and safeguards that were applied, should be documented. Some considerations for applying the independence rules that are particularly pertinent to client acceptance and continuance decisions for HUD audit engagements are discussed in the remaining paragraphs of this section.

<u>Nonattest Services.</u> One concern related to meeting independence requirements is the effect of providing nonattest services to the client. For example, an auditor may be asked to provide tax return preparation services to the client. Concerns may arise that an auditor's independence has been impaired in these circumstances.

Certain regulatory bodies, such as the SEC, the Government Accountability Office, the Department of Labor, the Public Company Accounting Oversight Board, and state boards of accountancy, may have more restrictive independence requirements for nonattest services than those of the AICPA. According to ET 1.295.010.07, when such rules are applicable to the engagement, independence would be impaired if the member is not in compliance with the rules.

GAO Independence Requirements—*Government Auditing Standards*. Chapter 3 of the Yellow Book expands the conceptual framework approach for independence by making the requirements related to independence much clearer and adding guidance as it relates to nonaudit services. Among other things, it establishes independence standards and provides guidance on independence for auditors conducting financial audits, attestation engagements, reviews of financial statements, and performance audits under the Yellow Book. It emphasizes the importance of independence of the auditor and the audit organization and provides examples of nonaudit services that can impair independence. Chapter 3 of the Yellow Book relates to independence and nonaudit services, including how auditors evaluate the nonaudit services they perform and whether the performance of those services create significant threats that require safeguards to reduce those threats to an acceptable level. When nonaudit services are performed, an evaluation should be made to determine if the service creates a threat to independence, and the evaluation must be documented. The Yellow Book includes requirements and application guidance on independence in Paragraphs 3.17-.108. The requirements relating to independence are provided by topic in the following paragraphs:

- General (Paragraphs 3.18-.20)
- GAGAS Conceptual Framework Approach to Independence (Paragraphs 3.27–.34)
- Independence Impairments (Paragraphs 3.59–.60)
- Nonaudit Services (Paragraphs 3.64)
- Management Responsibilities (Paragraphs 3.73–.78)
- Providing Nonaudit Services (Paragraphs 3.83–.84)
- Preparing Accounting Records and Financial Statements (Paragraphs 3.87–3.90)
- Internal Audit Assistance Services Provided by External Auditors (Paragraph 3.96)
- Internal Control Evaluation as a Nonaudit Service (Paragraphs 3.97–.98)
- Information Technology Services (Paragraph 3.102)
- Appraisal, Valuation, and Actuarial Services (Paragraph 3.104)
- Other Nonaudit Services (Paragraph 3.106)
- Documentation (Paragraph 3.107)

The following paragraphs address some of the requirements in the Yellow Book.

The Yellow Book requires the auditor to be independent during any period of time that falls within the period covered by the financial statements to be audited. Thus, its independence requirements should be applied for an engagement from the start of the entity's fiscal year.

According to Paragraphs 3.20 and 3.23 of the Yellow Book, the auditor should be independent from an audited entity during both of the following periods of time:

- Any period of time that falls within the period covered by the financial statements or subject matter of the engagement.
- The entire period of the professional engagement, which begins when the auditor signs the engagement letter (or other agreement to perform an audit) or actually begins to perform an engagement, whichever is earlier.

The period of the professional engagement does not necessarily end when the report is issued. It spans the entire duration of the professional relationship (which, for recurring audits, could cover several periods) and ends with the notification by either party of the termination of the relationship or by issuance of a report, whichever is later.

<u>The Meaning of Independence.</u> Paragraph 3.18 of the Yellow Book states, "In all matters relating to the GAGAS engagement, auditors and the audit organizations must be independent from an audited entity."

Independence includes both independence of mind and independence in appearance.

- *Independence of mind* is the state of mind that enables performing an audit without being affected by influences that compromise professional judgment, thereby allowing the auditor to act with integrity and to exercise objectivity and professional skepticism.

- *Independence in appearance* is the absence of circumstances that would cause a reasonable and informed third party, having knowledge of the relevant information, to reasonably conclude that the integrity, objectivity, or professional skepticism of an audit organization or member of the audit team had been compromised.

Paragraphs 3.19 and 3.22 of the Yellow Book explain that the auditor should avoid situations that could lead reasonable and informed third parties to conclude that the auditor is not independent and, thus, not capable of exercising objective and impartial judgment on all matters associated with conducting and reporting on the audit.

For purposes of independence, the Yellow Book indicates that offices or units of an audit firm or related or affiliated entities under common control are not differentiated from each other (i.e., they are all considered one organization/ firm); therefore, all of these entities must be independent. Paragraph 3.35 of the Yellow Book also indicates that common ownership, regardless of the level of control, may affect the appearance of independence.

In certain engagements, the party requesting an engagement (i.e., the engaging party) may not be the party responsible for the subject matter of the engagement (i.e., the responsible party). According to Paragraph 3.24 of the Yellow Book, the independence requirements apply to the auditor's relationship with the responsible party and not the relationship with the engaging party.

<u>Conceptual Framework for Independence.</u> The Yellow Book's conceptual framework is discussed beginning in Paragraph 3.26 of the Yellow Book. The requirements are listed in Paragraphs 3.27–.34 and the application guidance is provided in Paragraphs 3.35–.58.

Paragraph 3.27 of the Yellow Book state that the conceptual framework should be applied at the audit organization, engagement team, and individual auditor levels to:

- Identify threats to independence.
- Evaluate the significance of identified threats, both individually and in the aggregate.
- Apply safeguards as necessary to eliminate the threats or reduce them to an acceptable level. (Paragraph 3.46 of the Yellow Book indicates that threats are considered to be at an acceptable level when a third party would likely conclude that the audit organization or auditor is independent.)

Paragraph 3.28 of the Yellow Book requires auditors to reevaluate threats to independence, including any safeguards applied, whenever the audit organization or the auditors become aware of new information or changes in facts and circumstances that could affect whether a threat has been eliminated or reduced to an acceptable level.

<u>Threats to Independence.</u> Paragraph 3.28 of the Yellow Book requires auditors to reevaluate threats to independence, including any safeguards applied, whenever the audit organization or the auditors become aware of new information or changes in facts and circumstances that could affect whether a threat has been eliminated or reduced to an acceptable level.

Threats to independence are circumstances or activities that could—but do not necessarily—impair independence. Threats to independence may be created by a wide range of relationships and circumstances, including starting a new audit, assigning new staff to an ongoing audit, and performing a nonaudit service for an audited entity. The auditor should evaluate threats to independence (considering both qualitative and quantitative factors) for any activity not specifically prohibited in the Yellow Book. Paragraph 3.30 of the Yellow Book lists the following broad categories of threats that the auditor should evaluate:

- Self-interest threat—the threat of a financial or other interest inappropriately influencing the auditor's judgment or behavior. Self-interest threat—the threat of a financial or other interest inappropriately influencing the auditor's judgment or behavior. Paragraph 3.38 of the Yellow Book provides the following examples of circumstances that create self-interest threats:
  - An audit organization with dependence on income from a specific audited entity.
  - An audit team member negotiating employment with an audited entity.

    - An audit organization's discovery of a significant error while evaluating the results of a service provided by the audit organization.
    - An audit team member with a direct financial interest in the audited entity. (An exception is provided for auditors that are auditing certain pension plans in which they participate.)

- Self-review threat—the threat that, when making a judgment significant to a Yellow Book engagement, the auditor or audit organization will not appropriately evaluate judgments made or work performed as part of nonaudit services they previously provided. Paragraph 3.39 of the Yellow Book provides the following examples of circumstances that create self-review threats:
    - Issuing a report on the effectiveness of the operation of a financial or performance management system that the audit organization designed or implemented.
    - Preparing original data used to generate records that are the subject matter of the engagement.
    - Providing a service for an audited entity that affects the data that is the subject matter of the engagement.
    - An audit team member that is or was recently employed by the audited entity in a position with significant influence over the subject matter of the engagement.
- Bias threat—the threat of the auditor taking a position that is not objective because of his or her political, ideological, social, or other convictions. The Yellow Book, Paragraph 3.40, provides the following examples of circumstances that create bias threats:
    - An engagement team member with strong preconceptions that could affect the auditor's objectivity about the objective of a program under audit.
    - An engagement team member with political, ideological, or social convictions due to membership, employment, or loyalty to a particular group that could affect the auditor's objectivity.
- Familiarity threat—the threat that aspects of a relationship (such as a close or long relationship with the client or that of an immediate or close family member) with the audited entity's management or other personnel will lead the auditor to take a position that is not objective. Paragraph 3.41 of the Yellow Book provides the following examples of circumstances that create familiarity threats:
    - An engagement team member's close or immediate family member is a key official or senior manager of the audited entity or is employed in a position to exert significant influence over the subject matter of the engagement.
    - A key official or senior manager of the audited entity who has significant influence over the subject matter of the engagement and recently served on the engagement team.
    - An auditor's acceptance of gifts or preferential treatment (unless trivial or inconsequential) from an audited entity.
    - Senior members of the engagement team with a long association with the audited entity.
- Undue influence threat—the threat of external influences or pressures affecting the auditor's ability to make objective judgments. Among others, Paragraph 3.42 of the Yellow Book provides the following examples of circumstances that create undue influence threats:
    - External interference or influence that could improperly limit the scope of an engagement (or threaten to do so), including the extent and nature of work performed or transactions selected for testing.
    - Unreasonable pressure to reduce fees or to restrict time spent on an engagement.
    - Restrictions on audit organization resources that adversely affect its ability to perform its responsibilities.
    - Authority to inappropriately influence the contents of the auditor's report.

- - Threat of replacing the auditor based on a disagreement over the contents of the auditor's report, conclusions, or application of an accounting principle.

- Management participation threat—the threat resulting when an auditor takes on the role of management or performs management functions that will lead the auditor to take a position that is not objective. The Yellow Book, Paragraph 3.43, provides the following examples of circumstances that create management participation threats:

  - An engagement team member that is or was recently a key official or senior manager of the audited entity.

  - An audit team member serving as a voting member of a committee or board that makes policy decisions, supervises employees, or operates programs of the audited entity.

  - Recommending an individual or influencing the selection of personnel for a position that is key to the audited entity or program being audited.

  - Preparing management's corrective actions for findings and deficiencies identified during the engagement.

- Structural threat—the threat that an audit organization's position within a government, combined with the structure of that government will impact the audit organization's ability to conduct its work and report results objectively. Paragraph 3.44 of the Yellow Book indicates that an audit function (both internal and external) that is structurally within the reporting line of the area under audit is an example of a circumstance that creates a structural threat.

Whether independence is impaired depends on (a) the nature of the threat, (b) whether it is of such significance that it would compromise the auditor's integrity, objectivity, and professional skepticism or create the appearance that it may be compromised, and (c) the specific safeguard applied to eliminate the threat or reduce it to an acceptable level.

Safeguards. Safeguards are actions or measures designed, individually or in the aggregate, to eliminate threats or reduce them to an acceptable level. The auditor applies safeguards that address the specific facts and circumstances relating to significant threats. In some cases, it may be necessary to apply multiple safeguards. Safeguards might be available within the audit organization (e.g., having the work reviewed by a professional staff member who is proficient in HUD audits or Single Audits but who was not a member of the audit team or removing an auditor from the engagement team whose interests pose a threat to independence) or they might be externally sourced (e.g., consulting with a professional regulatory body or having another audit organization perform or reperform part of the engagement). ET 1.000.010.18 provides similar guidance.

The auditor should determine whether identified threats (a) are at an acceptable level, (b) have been reduced to an acceptable level, or (c) have been eliminated. Both qualitative and quantitative factors should be evaluated when determining a threat's significance. Also, because threats can have a cumulative effect on independence, the auditor should evaluate threats both individually and in the aggregate.

The GAS/SA Audit Guide, Paragraph 2.13, and Yellow Book, Paragraph 3.47, explain that a threat to independence is not at an acceptable level if it could—

- affect the auditor's ability to perform an engagement without being affected by influences that compromise professional judgment; or

- expose the auditor to circumstances that would cause a reasonable and informed third party to conclude that the integrity, objectivity, or professional skepticism of the audit organization, or an auditor, had been compromised.

The auditor should determine whether safeguards can be applied to any threats that are not at an acceptable level in order to eliminate them or reduce them to an acceptable level. When auditors determine that threats to independence require the application of safeguards, Paragraph 3.33 of the Yellow Book requires the auditor to document the threats identified and safeguards applied. In making that determination, the auditor should exercise professional judgment and take into account the need for both independence of mind and independence in appearance. The Yellow Book, Paragraph 3.63, provides factors to consider in determining if an engagement team's or audit organization's independence has been impaired by an individual auditor's impairment.

Auditors should evaluate threats both individually and in the aggregate because threats can have a cumulative effect on an auditor's independence. Furthermore, the evaluation of threats should be ongoing throughout the audit. The Yellow Book, Paragraph 3.28, states that if relevant new information about a threat to independence comes to the auditor's attention during the audit that could affect whether a threat has been eliminated or reduced to an acceptable level, the auditor should reevaluate threats, including any safeguards applied.

If the application of safeguards has not eliminated an unacceptable threat or reduced it to an acceptable level, the auditor should conclude that independence is impaired. Paragraph 3.60 of the Yellow Book explains that, when the auditor concludes independence is impaired, the auditor should decline to accept an engagement or should terminate an engagement that has had already started.

<u>Independence Threat Identified after Report Is Issued.</u> If a threat to independence is identified after the auditor's report is issued, the auditor should evaluate its impact on the audit and on compliance with *Government Auditing Standards*. Paragraph 3.34 of the Yellow Book states that if the newly identified threat impacted the audit and if the report would have been different from the one that was issued, the auditor should communicate in the same manner as originally used to distribute the report to those charged with governance, appropriate entity officials, appropriate officials of organizations requiring or arranging for the audit, and other known users.

If the report had been publicly accessible on the auditor's website, the auditor should remove the report and provide a notification about its removal. The auditor should determine whether it is necessary to perform additional audit procedures in order to reissue the report, including revised findings or conclusions. If the additional audit work does not result in revised findings or conclusions, the original report could be reposted.

<u>Nonaudit Services.</u> Auditors typically provide a range of nonaudit services for entities for which they also perform audits. The authors have been informed that the GAO's unofficial position is that any service the auditor provides that is not in the SASs is a *nonaudit service* (e.g., assisting with preparation of the financial statements, preparing cash-to-accrual conversions, and preparing reconciliations are designated as nonaudit services in Paragraph 3.70 of the Yellow Book).

The Yellow Book, Paragraph 3.64, indicates that an auditor should determine whether providing nonaudit services would create a threat to independence (by itself or in aggregate with other nonaudit services) before agreeing to provide such services. Certain nonaudit services are identified in the Yellow Book as services that always impair auditor independence. Other nonaudit services are permitted if specific criteria are met.

Routine activities that directly relate to an engagement, such as providing advice and responding to questions on an informal basis as part of an audit, are not considered nonaudit services. Routine activities usually require only insignificant amounts of time or resources and do not entail (a) a specific project or engagement or (b) the production of a report or other formal work product. Paragraph 3.71 of the Yellow Book clarifies that routine activities that directly relate to an audit include the following:

- Providing advice on an accounting matter as an ancillary part of the financial audit.
- Providing advice on routine business matters.
- Educating the entity on matters within the auditors' technical expertise.
- Providing information that is readily available to the auditors, such as best practices and benchmarking studies.

Prohibited Nonaudit Services. Exhibit 1-1 lists the services the Yellow Book identifies as specific nonaudit services that always impair independence. Other types of services will also impair independence.

Exhibit 1-1

Services Identified in the Yellow Book as Impairing Independence

Requirement Area	Yellow Book Requirement
Management Responsibilities	Auditors should conclude that management responsibilities that the auditors perform for an audited entity are impairments to independence. If the auditors were to assume management responsibilities for an audited entity, the management participation threats created would be so significant that no safeguards could reduce them to an acceptable level. (Para. 3.78) Paragraph 3.81 lists the following activities that are considered management responsibilities. However, Paragraph 3.82 notes that whether a specific activity is a management responsibility depends on the facts and circumstances.
Preparing Accounting Records and Financial Statements	Auditors should conclude that the following services involving preparation of accounting records impair independence with respect to an audited entity: (Para. 3.87) a. determining or changing journal entries, account codes or classifications for transactions, or other accounting records for the entity without obtaining management's approval; b. authorizing or approving the entity's transactions; and c. preparing or making changes to source documents without management approval.
Internal Audit Assistance Services Provided by External Auditors	Internal audit assistance services involve assisting an entity in performing its internal audit activities. Auditors should conclude that the following internal audit assistance activities impair an external auditor's independence with respect to an audited entity: (Para. 3.96) a. setting internal audit policies or the strategic direction of internal audit activities; b. performing procedures that form part of the internal control, such as reviewing and approving changes to employee data access privileges; and c. determining the scope of the internal audit function and resulting work.
Internal Control Evaluation as a Nonaudit Service	Auditors should conclude that providing or supervising ongoing monitoring procedures over an entity's system of internal control impairs independence because the management participation threat created is so significant that no safeguards could reduce the threat to an acceptable level. (Para. 3.97)

<table>
<tr><th>Requirement Area</th><th>Yellow Book Requirement</th></tr>
<tr><td>Information Technology Services</td><td>Auditors should conclude that providing information technology (IT) services to an audited entity that relate to the period under audit impairs independence if those services include: (Para. 3.102)
a. designing or developing an audited entity's financial information system or other IT system that will play a significant role in the management of an area of operations that is or will be the subject matter of an engagement;
b. making other than insignificant modifications to source code underlying an audited entity's existing financial information system or other IT system that will play a significant role in the management of an area of operations that is or will be the subject matter of an engagement;
c. supervising audited entity personnel in the daily operation of an audited entity's information system; or
d. operating an audited entity's network, financial information system, or other IT system that will play a significant role in the management of an area of operations that is or will be the subject matter of an engagement.</td></tr>
<tr><td>Appraisal, Valuation, and Actuarial Services</td><td>Auditors should conclude that independence is impaired if an audit organization provides appraisal, valuation, or actuarial services to an audited entity when (1) the services involve a significant degree of subjectivity and (2) the results of the service, individually or when combined with other valuation, appraisal, or actuarial services, are material to the audited entity's financial statements or other information on which the audit organization is reporting. (Para. 3.104)</td></tr>
</table>

Requirement Area	Yellow Book Requirement
Other Nonaudit Services	Auditors should conclude that providing certain other nonaudit services impairs an external auditor's independence with respect to an audited entity. These activities include the following: (Para. 3.106) a. Advisory service (1) Assuming any management responsibilities b. Benefit plan administration (1) Making policy decisions on behalf of management (2) Interpreting the provisions in a plan document for a plan participant on behalf of management without first obtaining management's concurrence (3) Making disbursements on behalf of the plan (4) Having custody of the plan's assets (5) Serving in a fiduciary capacity, as defined under the Employee Retirement Income Security Act of 1974 c. Business risk consulting (1) Making or approving business risk decisions (2) Presenting business risk considerations to those charged with governance on behalf of management d. Executive or employee recruiting (1) Committing the audited entity to employee compensation or benefit arrangements (2) Hiring or terminating the audited entity's employees e. Investment advisory or management (1) Making investment decisions on behalf of management or otherwise having discretionary authority over an audited entity's investments (2) Executing a transaction to buy or sell an audited entity's investments (3) Having custody of an audited entity's assets, such as taking temporary possession of securities

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Criteria for Providing Nonaudit Services (That Are Not Prohibited). If a nonaudit service is not specifically prohibited (i.e., not identified as always impairing independence), Paragraph 3.86 of the Yellow Book explains that the auditor may provide certain nonaudit services without impairing independence if all of the following conditions are met:

- The nonaudit services are not expressly prohibited by GAGAS requirements.
- The auditor has determined that the requirements set forth in Paragraphs 3.78 and 3.83 of the Yellow Book for performing nonaudit services have been met.
- Any significant threats to independence have either been eliminated or reduced to an acceptable level by applying safeguards.

A flowchart to assist the auditor in determining whether the auditor is independent and a nonaudit service is permitted is provided in Figures 1 and 2 to Chapter 3 of the Yellow Book.

Paragraph 3.67 of the Yellow Book explains that a nonaudit service performed during the period covered by the financial statements might not impair the auditor's independence with respect to those financial statements if the following conditions are met:

- The nonaudit service was provided before the period of professional engagement.
- The nonaudit service related only to periods prior to that of the financial statements.
- The financial statements for the period to which the nonaudit service relates were audited by another auditor.

An auditor who previously provided nonaudit services for a prospective audit client should evaluate the impact of the services on independence before accepting the audit engagement. If the nonaudit service was provided in the period to be audited, the auditor should—

- Determine if the nonaudit service is specifically prohibited;
- If management requested the nonaudit service, determine whether the skills, knowledge, or experience (SKE) of the individual overseeing the service were sufficient; and
- if management did not request the nonaudit service, determine whether a threat to independence exists and address any threats in accordance with the conceptual framework.

Before accepting an engagement to perform a nonaudit service requested by an audited entity's management that could be a threat to independence, the auditor should—

- Determine that the entity has designated an individual who has suitable skill, knowledge, or experience, and who understands the services to be performed sufficiently to oversee them. [Yellow Book, para 3.73]
- Obtain assurance that the client will assume all management responsibilities in connection with the nonaudit services; designate someone (preferably within senior management) who has suitable skills, knowledge, and/or experience to oversee the services; evaluate the adequacy and results of the services; and accept responsibility for the results. [Yellow Book, para. 3.76]
- Establish an understanding with management about the nonaudit service to be provided, the objectives of the service, any limitations of the service, the entity's acceptance of its responsibilities, and the auditor's responsibilities. [Yellow Book, para 3.77]

Related documentation requirements are discussed later in this section.

Consideration of SKE. It is critically important for auditors to carefully evaluate the skill, knowledge, and experience (SKE) of the individual designated to oversee the nonaudit services and to thoroughly document that evaluation. The GAS/SA Audit Guide, Paragraph 2.22, explains that although the auditor has to determine whether the entity has designated an individual who has suitable skill, knowledge, or experience, and who understands the nonaudit services sufficiently to oversee them, the individual does not need the expertise to perform or reperform the services. The Yellow Book states that indicators of management's ability to oversee a service includes the ability to determine the reasonableness of the results and to recognize a material error, omission, or misstatement in the results of the service. If an entity does not have someone with suitable SKE as it relates to the nonaudit service, performing the service would impair independence. Paragraph 3.74 of the Yellow Book requires that the auditor document the consideration of management's ability to effectively oversee the nonaudit services to be performed regardless of whether the threats to independence are determined to be significant.

Nonaudit Services Involving Preparing Accounting Records and Financial Statements. The Yellow Book, Paragraph 3.88, states that "auditors should conclude that preparing financial statements in their entirety from a client-provided trial balance or underlying accounting records creates *significant threats* to auditors' independence, and should document the threats and safeguards applied to eliminate and reduce threats to an acceptable level . . . or decline to provide the services." [Emphasis added.] Nonaudit services that create a significant threat to independence may be performed if safeguards are applied to eliminate or reduce the threat to an acceptable level.

Paragraph 3.89 of the Yellow Book states that "auditors should identify as threats to independence any services relating to preparing accounting records and financial statements, other than those defined as impairments to independence in paragraph 3.87 (see Exhibit 1-1) and significant threats in paragraph 3.88." The following services related to preparing accounting records and financial statements should be defined as threats to independence:

- Recording transactions for which management has determined or approved the account classifications or posting coded transactions to the general ledger.
- Preparing certain line items or sections of the financial statements based on the trial balance.
- Posting entries that management has approved to the trial balance.
- Preparing account reconciliations that identify reconciling items for management's evaluation.

Paragraph 3.90 of the Yellow Book requires auditors to (a) evaluate the significance of threats to independence created by providing any of these services and (b) document the evaluation of the significance of such threats.

When threats are considered significant, auditors must apply safeguards to eliminate or reduce the threats to an acceptable level. Paragraphs 3.93–.95 of the Yellow Book provide application guidance about evaluating the significance of threats. Paragraphs 3.93–.94 remind auditors that determining whether nonaudit services are significant threats and require safeguards is a matter of professional judgment and provide the following factors as being relevant in evaluating the significance of the threats:

- Extent to which the outcome of the nonaudit service could have a material effect on the financial statements.
- Degree of subjectivity involved in determining the amounts or treatments for matters in the financial statements.
- Extent of management's involvement in determining significant matters of judgment.

In addition, the Yellow Book clarifies that providing clerical assistance (e.g., typing, formatting, printing, binding) is unlikely to be a significant threat.

Paragraph 3.69 of the Yellow Book provides the following examples as safeguards that could be applied in certain situations to address identified threats related to nonaudit services:

- Not including individuals that provided the nonaudit service on the audit team.
- Having another auditor, not associated with the engagement, review the engagement and nonaudit service.
- Engaging another audit organization to evaluate the results of the nonaudit service.
- Engaging another audit organization to reperform the nonaudit service to the extent necessary to enable the other audit organization to take responsibility for the service.

Documentation. The Yellow Books establishes specific documentation requirements related to independence. Paragraph 3.107 of the Yellow Book requires the auditor to document the following:

- Threats to independence that require the application of safeguards and the safeguards applied to eliminate or reduce the threats to an acceptable level [paras. 3.33 and 3.52–.56].
- The auditor's consideration of management's ability to effectively oversee nonaudit services [para. 3.74].
- The understanding with the entity about the nonaudit service to be provided, the objectives of the service, any limitations of the service, the entity's acceptance of its responsibilities, and the auditor's responsibilities [para 3.77].
- Evaluation of the significance of threats created by providing the services discussed in paragraph [paras. 3.89–.90].

- Applicable safeguards if the audit organization is structurally located within a government entity and is considered independent based on those safeguards [para. 3.107].

The Yellow Book also requires the auditor to document the evaluation of the significance of threats created by providing services related to preparing accounting records and financial statements. Such services include the following: [Yellow Book, para. 3.89]

- Recording transactions for which management has determined or approved.
- Preparing certain line items or sections of the financial statements based on information in the trial balance.
- Posting entries that an audited entity's management has approved to the entity's trial balance.

Auditors should document the threats and safeguards applied to eliminate and reduce threats to an acceptable level for these items as well as the significant threat created by preparing financial statements in their entirety from a client-provided trial balance or underlying accounting records. If the threats cannot be eliminated or reduced to an acceptable level, the auditor must decline to provide the services.

Interpretation on Hosting Services. The AICPA's Professional Ethics Executive Committee (PEEC) adopted an ethics interpretation, *Hosting Services*, at ET 1.295.143, which was effective on July 1, 2019. Under the interpretation, hosting services are nonattest services where the member accepts responsibility for:

- Being the sole host of an attest client's financial or nonfinancial information system.
- Having custody or storing the data or records of an attest client that are only available to the attest client through the member.
- Providing back-up or electronic security services for the data or records of an attest client.

Hosting services are addressed in the PEEC's listing of Frequently Asked Questions (FAQs), which is available at **https://us.aicpa.org**.

Restriction on Auditors Preparing Indirect Cost Proposals. The Uniform Guidance, at 2 CFR 200.509(b), states that "an auditor who prepares the indirect cost proposal or cost allocation plan may not also be selected to perform the audit . . . when the indirect costs recovered by the auditee during the prior year exceeded $1 million." This restriction relates to all years covered by the indirect cost proposal or cost allocation plan, including the base year used in the calculation and any subsequent years in which the agreement or plan is used to recover costs. *Government Auditing Standards* also addresses independence requirements for auditors who prepare indirect cost proposals or cost allocation plans. Under the Yellow Book, activities such as preparation of indirect cost proposals or cost plans are nonaudit services that should be evaluated using the Yellow Book's conceptual framework.

HUD Independence Requirements. HUD Handbook 4370.2 REV-1, *Financial Operations and Accounting Procedures for Insured Multifamily Projects*, states that a person who performs manual or automated bookkeeping services for a HUD client or maintains its accounting records is prohibited from performing audits of the client's financial statements. According to HUD policy, however, neither "accounting systems work" nor tax preparation services preclude auditors from performing HUD audits. HUD Handbook 4470.1 REV-2, *Mortgage Credit Analysis for Project Mortgage Insurance*, further restricts the independence of auditors who perform cost certification audits of mortgagors and general contractors by prohibiting any business or financial relationship with the client outside of the performance of the audit.

Professional Judgment

The Yellow Book, in Paragraph 3.109, establishes an unconditional (i.e., "must") requirement for auditors to use professional judgment in planning, performing, and reporting on audits. Paragraph 3.110 of the Yellow Book indicates that the concept of reasonable care requires auditors to act diligently in accordance with applicable professional standards and ethical principles. Exercising professional skepticism entails a critical assessment of audit evidence while assuming that management is neither dishonest nor of unquestioned honesty. Additionally, Paragraph 3.110 of the Yellow Book states that auditors may accept records and documents as genuine unless they have reason to believe the contrary. Auditors may consider documenting procedures undertaken to support their application of professional skepticism in highly judgmental or subjective areas under audit.

The Yellow Book clearly states that professional judgment is both an organizational and individual responsibility. Paragraph 3.112 of the Yellow Book states—

> Professional judgment represents the application of the collective knowledge, skills, and abilities of all the personnel involved with an engagement, as well as the professional judgment of individual auditors. In addition, professional judgment may involve consultation with other stakeholders, specialists, and management in the audit organization.

Paragraph 3.113 of the Yellow Book indicates that applying professional judgment includes—

- following the independence standards and related conceptual framework;
- maintaining objectivity and credibility;
- assigning competent staff/personnel to the engagement;
- defining the scope of work;
- evaluating, documenting, and reporting the results of the work; and
- maintaining appropriate quality control over the engagement process.

The GAS/SA Audit Guide, Paragraph 2.41, provides the following additional considerations relative to exercising professional judgment:

- The use of professional knowledge, skills, and abilities to diligently gather information, in good faith and with integrity, and to objectively evaluate the sufficiency and appropriateness of evidence is a critical component of an audit. Professional judgment and competence are interrelated because judgments made are dependent upon the auditor's competence.
- Professional judgment represents the application of the collective knowledge, skills, and abilities of all the personnel involved with an audit, as well as the professional judgment of individual auditors. Professional judgment may also involve collaboration with other stakeholders, specialists, and management in the audit organization.
- The use of professional judgment is important in performing all aspects of auditors' professional responsibilities, including following the independence standards and related conceptual framework; maintaining objectivity and credibility; assigning competent staff to the audit; defining the scope of work; evaluating, documenting, and reporting the results of the work; and maintaining appropriate quality control over the audit process.
- The use of professional judgment is important when applying the conceptual framework to determine independence for a specific situation. This includes identifying and evaluating any threats to the auditor's independence, including threats to the appearance of independence, and related safeguards that may mitigate the identified threats.
- The use of professional judgment is important in determining the required level of understanding of the audit subject matter and related circumstances. This includes consideration of whether the audit team's collective experience, training, knowledge, skills, abilities, and overall understanding are sufficient to assess the risks that the subject matter of the audit may contain a significant inaccuracy or could be misinterpreted.
- The consideration of the audit risk level, including the risk of arriving at improper conclusions, is also important. Exercising professional judgment in determining the sufficiency and appropriateness of evidence to be used to support the findings, conclusions, and any recommendations is an integral part of the audit process.

Government Auditing Standards places responsibility on each auditor and the audit organization to exercise professional judgment in planning and performing an audit. However, it does not imply unlimited responsibility or infallibility on the part of an auditor or the audit organization.

Competency and Continuing Education

GAAS Requirements. SQCS No. 8 (QM 10A.33), *A Firm's System of Quality Control*, requires firms to adopt quality control policies and procedures that provide reasonable assurance that the engagement partner (or other individual responsible for supervising the engagement and signing or authorizing someone else to sign the auditor's report) has the necessary competencies for the engagement. The necessary competencies will vary depending on the client, industry, or type of service being provided. While not mentioned in the statement, the authors believe that audits of HUD-assisted entities would also require different competencies. The quality control policies and procedures should also require that the lead engagement partner have the appropriate capabilities, authority, and time to perform the role. Policies and procedures may include systems to monitor the workload and availability of engagement partners so as to allow these individuals to have sufficient time to adequately perform their responsibilities. AU-C 220A.16 requires the engagement partner to be satisfied that the engagement team has the appropriate competence and capabilities to (a) perform the audit in accordance with professional standards and relevant legal and regulatory requirements, and (b) enable the issuance of an auditor's report that is appropriate in the circumstances.

SQCS No. 8 explains that competencies and capabilities are the knowledge, skills, and abilities that qualify personnel to perform engagements and, that overall, competency is qualitative rather than quantitative. Competencies and capabilities are developed through a variety of methods, such as professional education, continuing professional development and training, work experience, and mentoring. Required competencies vary depending on the client, industry, or type of service being provided.

The auditor contemplating a HUD engagement ought to consider whether he or she has the necessary experience in the area or can obtain sufficient knowledge and understanding to perform the services requested through continuing education courses; attendance at relevant conferences; discussions with knowledgeable persons; etc. The AICPA and most state licensing authorities have continuing education requirements for CPAs. In fulfilling these requirements, particular attention can be given to accounting, auditing, and tax matters relevant to HUD-assisted multifamily housing projects.

Government Auditing Standards **Requirements.** The general standard related to competence in the Yellow Book, beginning at Paragraph 4.02, states that the staff assigned to perform the audit must collectively possess adequate professional competence needed to address the audit objectives and perform the work in accordance with *Government Auditing Standards*. The Yellow Book, Paragraph 4.03, indicates that the audit organization's management must assign auditors who before beginning work on the engagement possess the competence needed for their assigned roles. Competence is considered to include education, experience, and a commitment to life-long learning. Audit firms should assess skill needs to consider whether its workforce has the essential skills that match those necessary to perform the particular audit. The GAS/SA Audit Guide, Paragraph 2.44, explains that audit organization's management must assign auditors who, before beginning work on the audit, possess the competence needed for their assigned roles. Staff assigned to a Yellow Book audit should collectively possess:

- Knowledge of *Government Auditing Standards* applicable to the type of work they are assigned and the education, skills, and experience to apply the knowledge to the work being performed
- General knowledge of the environment in which the auditee operates and the subject matter.
- Skills to enable clear and effective oral and written communication.
- Other skills appropriate for the work being performed; for example, skills in—
  - statistical or nonstatistical sampling if the work involves use of sampling;
  - information technology if the work involves review of information systems;
  - engineering if the work involves review of complex engineering data;

- specialized audit methodologies or analytical techniques, such as the use of complex survey instruments, actuarial-based estimates, or statistical analysis tests, as applicable; or
- specialized knowledge in subject matters, such as scientific, medical, environmental, educational, or any other specialized subject matter if the work calls for such expertise.

Auditors should also be knowledgeable in GAAS, the financial reporting framework that is used, and any other standards used in conjunction with *Government Auditing Standards*.

Paragraph 4.02 of the Yellow Book indicates that management must assign auditors to conduct the engagement who before the beginning of the engagement collectively possess the competence to achieve the engagement objectives and perform their work in accordance with *Government Auditing Standards*. Paragraph 4.05 of the Yellow Book states that "competence is the knowledge, skills, and abilities, obtained from education and experience, necessary to conduct the GAGAS engagement." Paragraph 4.07 of the Yellow Book states that the knowledge, skills, and abilities needed when conducting an engagement in accordance with GAGAS include the understanding necessary to proficiently apply:

- GAGAS.
- Standards, statutory requirements, regulations, criteria, and guidance applicable to auditing or the objectives for the engagement(s) being conducted.
- Techniques, tools, and guidance related to professional expertise applicable to the work being performed.

The Yellow Book, at Paragraph 4.08, states that achieving the knowledge, skills, and abilities needed to conduct a GAGAS engagement may include:

- Having prior experience in the subject matter or type of engagement.
- Completing CPE related to the subject matter or type of engagement.
- Obtaining degrees or certifications relevant to the subject matter or type of engagement.

The Yellow Book, at Paragraph 4.04, states that the audit organization should have a process for recruitment, hiring, continuous development, assignment, and evaluation of personnel so that the workforce has the essential knowledge, skills, and abilities necessary to conduct the engagement.

The Yellow Book, at Paragraph 6.04, also requires that auditors either be licensed CPAs, be licensed accountants in states with multi-class licensing systems that recognize licensed accountants other than CPAs, or work for a licensed CPA firm or a government auditing organization.

The Yellow Book continuing education requirements are included as part of the competence general standard. The requirements are summarized below.

<u>80-hour and 24-hour Requirements.</u> The Yellow Book states that every two years, each auditor performing work in accordance with the Yellow Book, including planning, directing, performing audit procedures, or reporting on an audit under the Yellow Book, should complete every two years, at least 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates. In addition, auditors who do any amount of planning, directing, or reporting on Yellow Book engagements and auditors who are not involved in those activities but charge at least 20% of their time annually to Yellow Book engagements should also obtain at least another 56 hours (for a total of 80 hours) of CPE that enhances their professional proficiency to perform audits. In other words, everyone working on a Yellow Book engagement should meet the 24-hour requirement. However, auditors who do not do any planning, directing, or reporting on a Yellow Book engagement, or who do not spend at least 20% of their time annually on Yellow Book engagements are not required to obtain an additional 56 hours of CPE in auditing to comply with the 80-hour requirement. (Yellow Book, Paragraphs 4.16 and 4.25) (It is important to note that the Yellow Book's CPE requirements apply whether the auditor is a CPA or is not certified.) Auditors who are required to comply with the 80-hour requirement have to complete at least 20 hours in each year of the two-year period. The Yellow Book allows nonsupervisory auditors who charge less than 40 hours of their time annually to engagements conducted in accordance with GAGAS to be

exempted by the organization from the 24-hour and 56-hour requirements (Yellow Book, Paragraph 4.26). Auditors hired or initially assigned to Yellow Book engagements after the beginning of an audit organization's two-year CPE period should complete a prorated number of CPE hours.

The Yellow Book, Paragraph 4.31, indicates that internal specialists (i.e., employees of the audit firm) who are performing work as part of the audit team, including directing, performing audit procedures, or reporting on the audit (planning is also included for engagements under the Yellow Book), should comply with the Yellow Book's CPE requirements. However, Paragraph 4.30 of the Yellow Book specifically exempts internal specialists who are *consulting* on a Yellow Book audit and are not involved in directing, performing audit procedures, or reporting on it (or planning under the Yellow Book) from the Yellow Book CPE requirements.

Paragraph 4.31 of the Yellow Book clarifies that the Yellow Book's CPE requirements become effective for internal specialists when they are first assigned to an audit. Because internal specialists apply specialized knowledge in government audits, training in their areas of specialization would meet the requirement for 24 hours of CPE that directly relates to government auditing, the government environment, or the specific or unique environment in which the audited entity operates.

Neither internal specialists who are *consulting* on a Yellow Book audit nor external specialists have to meet Yellow Book CPE requirements. However, Paragraph 4.31 of the Yellow Book requires the auditor to determine that internal specialists who are consulting on the engagement are qualified and competent in their areas of specialization. Paragraphs 4.12 and 4.30 of the Yellow Book establishes a similar requirement regarding external specialists.

The Yellow Book, at Paragraph 4.21, states that determining what CPE subjects are appropriate to satisfy CPE requirements is a matter of professional judgement to be exercised by auditors in consultation with appropriate officials in their audit organization. In deciding appropriate CPE courses, auditors consider their knowledge, skills, and abilities, and the level of proficiency necessary, in order to be competent for their assigned roles. Auditors may consider probable future engagements to which they may be assigned when selecting specific CPE subjects to satisfy the 24-hour and the 56-hour CPE requirements.

<u>Other Yellow Book Competence and CPE Requirements.</u> Audit organizations that have not previously been subject to the Yellow Book may perform Yellow Book audits. However, the organization must meet the competence standards discussed beginning at Paragraph 4.02 of the Yellow Book. For example, the auditor assigned to perform Yellow Book audits must *collectively possess* the knowledge, skills, and abilities, obtained from education and experience. Firms may also, at their discretion, grant exceptions from a portion of CPE requirements in extenuating circumstances (e.g., ill health, military service, disasters). Also, auditors who are hired or assigned to a Yellow Book audit after the beginning of the firm's measurement period should complete a prorated number of hours. (Yellow Book, Paragraph 4.42) Compliance with the continuing professional education requirements should be documented.

<u>Other Requirements and Guidance.</u> Guidance on choosing a CPE measurement period is provided in the Yellow Book, at Paragraph 4.48. Firms have flexibility in choosing the CPE measurement period. The measurement period does not have to coincide with the date a firm started its first Yellow Book engagement. Firms may want to use a measurement period that coincides with the firm's fiscal year or one that coincides with a licensing board's reporting requirement. Yellow Book CPE requirements must be met every two years. An audit organization may choose to establish a standard two-year measurement period for all of its auditors, which can be on either a fixed-year or rolling-year basis. [A fixed-year basis would be, for example, 20X1–20X2 or 20X3–20X4. A rolling-year basis would be something like 20X1 (12 months) plus 20X2 (12 months); 20X2 (12 months) plus 20X3 (12 months).] The authors recommend that firms not use a rolling-year basis. Additional application guidance on measurement of CPE is included in Paragraphs 4.37–.49 of the Yellow Book.

The Yellow Book states that obtaining CPE specifically on GAGAS, particularly during years in which there are revisions to the standards, may assist auditors in maintaining the competence necessary to conduct GAGAS engagements. Paragraph 4.21 of the Yellow Book states that determining what subjects are appropriate for individual auditors to satisfy the CPE requirements is a matter of professional judgment and should be chosen in consultation with their audit organization, which is ultimately responsible for determining whether a subject or topic qualifies as acceptable for its auditors. Paragraph 4.23 of the Yellow Book lists examples of subject matter directly related to the government environment, government auditing, or the specific or unique environment in which the audited entity operates which may qualify to satisfy the 24-hour requirement. Paragraph 4.24 of the Yellow Book lists examples of subject matter that directly enhances auditor's professional expertise to conduct engagements which may qualify to satisfy the 56-hour requirement. Subject matter categories for the 24-hour requirement may be used to satisfy the 56-hour requirement, and if subject matter topics that would satisfy the 56-hour requirement are specifically tailored to the government environment, such CPE may also qualify to satisfy the 24-hour requirement. Additional application guidance on subject matter categories of CPE is included in Paragraphs 4.21–.24 of the Yellow Book.

The Yellow Book beginning at Paragraph 4.09 states that the audit organization and engagement teams may consider the levels of proficiency needed for each role on the engagement when assigning auditors to the engagements. Further, the Yellow Book defines roles on engagements generally as follows:

- *Nonsupervisory auditors*. Auditors in these roles plan or perform engagement procedures. Work situations for these auditors are characterized by low levels of ambiguity, complexity, and uncertainty. The nonsupervisory auditor role necessitates at least a basic level of proficiency.
- *Supervisory auditors*. Auditors in these roles plan engagements, perform engagement procedures, or direct engagements. Work situations for these auditors are characterized by moderate levels of ambiguity, complexity, and uncertainty. The supervisory auditor role necessitates at least an intermediate level of proficiency.
- *Partners and directors*. Auditors in these roles plan engagements, perform engagement procedures, or direct or report on engagements. Partners and directors may also be responsible for reviewing engagements quality prior to issuing the reports, for signing the report, or both. Work situations for these auditors are characterized by high levels of ambiguity, complexity, and uncertainty. The partner and director role necessitates an advanced level of proficiency.

REAC's Quality Assurance Process for Reliance on Independent Auditors

HUD's Real Estate Assessment Center (REAC) uses the Financial Assessment Subsystem -Multifamily Housing (FASSUB) to analyze the financial information of the approximately 26,000 HUD-assisted multifamily projects to determine their financial soundness and compliance with HUD laws and regulations. To gain reasonable assurance that those assessments are based on reliable financial and compliance data, HUD's REAC has developed a Quality Assurance Subsystem (QASS) whereby REAC auditors conduct several types of quality reviews of auditors that perform audits of HUD-assisted entities.

Selection Process. Independent auditors and HUD-assisted properties generally are statistically selected for review using a data-driven model with information from several sources including:

- Number of projects audited by auditor.
- Average audit fee.
- Amount of the project's federal financial assistance.
- Demographic data.

REAC personnel can also refer projects for review for other reasons, including problems with the project, past poor quality audits, and unusual financial fluctuations. In addition, some auditors are selected for review using a random sample.

Quality Review Types. Once an auditor and project is selected, the QASS auditor will begin a quality assurance review (QAR). Based on the results of the QAR, a verification review may also be performed. A limited scope engagement is performed on projects that do not have an independent auditor.

<u>Quality Assurance Review.</u> Performance of a quality assurance review is the first step in the auditor review process. (Depending on its results, a verification review may also be performed.) Its purpose is to determine whether the

project's auditor conducted the audit in compliance with applicable professional standards. Applicable checklists from the AICPA Peer Review Program Manual (PRP) are as follows:

- General Audit Engagement Checklist (PRP Section 20,400).
- Not-for-Profit Audit Engagement Checklist (PRP Section 20,600) (applicable for nonprofit HUD-assisted entities).

Depending on the type of entity (for-profit vs. nonprofit), QASS auditors also use two separate supplemental checklists for completion during the performance of the review:

- Supplemental Checklist for Review of Audits of For-profit Housing and Urban Development (HUD) Engagements (PRP Section 22,080).
- Supplemental Checklist for Review of Single Audit Engagements — Part A (Uniform Guidance) (PRP Section 22,100 Part A-UG).
- Supplemental Checklist for Review of Single Audit Engagements - Part B (Uniform Guidance) (PRP Section 22,100 Part B-UG).

Upon selection for a QAR, the REAC auditor performs the pre-review planning procedures by contacting the project auditor and holding an entrance conference to inquire about engagement staffing, audit risks and response to risk in audit approach, methodology for materiality, sampling methodology, internal control considerations, complex issues, and specific problems. When reviewing compliance with the general and fieldwork standards, the following documents are generally reviewed:

- CPA license(s) in jurisdiction of the auditor and the auditee.
- External quality control review report within the last three years.
- CPA firm's internal quality control policies and procedures.
- Engagement letter.

Other steps in this section address the performance of preliminary analytical review, follow-up on previous audit findings, and adequate supervision and review.

Under the FASS review portion of the checklist, the financial statement line items selected for review are tailored for each project based on those line items with the greatest impact on the project's financial ratios collected by FASSUB. The checklist contains steps for common financial statement line items. The internal control and compliance audit requirements portion of the checklist contains steps for reviewing internal control documentation and testing for both financial statement and compliance purposes. Additional steps address compliance testing, including determining whether all major programs were tested and whether adequate documentation exists regarding sample design. Other steps address obtaining a representation letter, performing the legal inquiry and subsequent events procedures, reporting audit findings, and auditor compliance with CPE and independence requirements.

In the wrap-up phase of the review, an exit conference is held where the project auditor has a chance to respond orally to any findings that would be incorporated in the final letter. In some cases a draft letter is issued providing the project auditor with the opportunity to respond in writing with the actions that will be taken on the identified deficiencies. A final letter is then issued to the project auditor, which may also be forwarded to the applicable project owner and HUD field office. The results are also maintained in a REAC database, which may be used for future quality assurance selection or for referral to the project auditor's state board of accountancy, the HUD Enforcement Center, the AICPA, or the appropriate state society.

Verification Review. A verification review may be conducted to confirm that an auditor actually performed the audit steps documented in the audit workpapers and that the steps were performed according to applicable audit standards, government regulations, and OMB and HUD audit guidance. An auditor may be selected for a verification review if the quality assurance review reveals there may be insufficient evidence in the workpapers to document that the recorded audit steps were actually performed. After the process is completed, the auditor will receive the verification review results in a separate section of the QAR results letter.

Limited Scope Engagement. A limited scope engagement is designed to review those projects that do not obtain an audit. Upon selection, the management office will be contacted with oral and written notification, including a document request list and an internal control questionnaire. The engagement will be performed on-site at the project location using a checklist to review financial controls, compliance controls, and account balances. Upon conclusion, an exit conference will be held explaining the results of the engagement. The results will be documented in a letter to the project owner and the applicable HUD field office.

HUD Review of Auditors' Workpapers. At HUD's request, auditors are obligated to provide access to or copies of their audit documentation to HUD. Based on guidance in an auditing interpretation at AU-C 9230.01–.15, *Providing Access to or Copies of Audit Documentation to a Regulator*, if the auditor is required by law, regulation, or audit contract to provide access to audit documentation to regulators, the auditor might do the following—

a. Consider advising the client that the regulator has requested access to (and possibly copies of) the audit documentation and the auditor intends to comply with such request.

b. Make appropriate arrangements with the regulator for the review.

c. Maintain control over the audit documentation. The interpretation indicates that the audit documentation may be made available for review at the client's office, the auditor's office, or a mutually agreed-upon location. However, it is necessary for the auditor to maintain control of the audit documentation in order for the integrity of the audit documentation and the confidentiality of client information to be maintained. The authors believe the auditor or a representative should always be present when the audit documentation is reviewed by a third party.

d. Consider submitting a letter to the regulator to confirm the auditor's understanding of the purpose for the regulator's review of the audit documentation. In addition, the communication should include confirmation of the confidentiality of the audit documentation.

The information above summarizes guidance provided by the Auditing Interpretation that the authors believe applies to HUD audits. Not all of the recommendations included in the interpretation are appropriate when responding to a request from a regulator (such as HUD) for access to workpapers. When requesting access to auditor's workpapers, HUD is functioning not as a regulator, but as a quality reviewer. The objective of the quality control review of a HUD audit is to assure that the audit was conducted in accordance with applicable professional standards and meets HUD audit requirements. Some of the guidance included in the interpretation of AU-C 230 (and not discussed above) relates to requests for access to workpapers for the purpose of regulating the client and not for determining if the audit was performed in accordance with applicable requirements and, therefore, does not apply to requests by HUD performing a quality control review.

The HUD audit guide, at Paragraph 1-5(A), states that the engagement letter must address the auditor's requirement to provide HUD, the HUD OIG, and the GAO or their representatives access to audit documentation (hardcopy or electronic) for their reviews, and that such access includes making necessary photocopies of hardcopy audit documentation or other documents or electronic copies of electronic audit documentation.

The HUD audit guide, Paragraph 1-7, cautions:

> Whenever HUD's evaluation of an audit report or audit documentation discloses inadequacies, the auditor may be asked to take corrective action. If HUD determines that the audit report or the audit documentation is substandard or contains major inadequacies, HUD may also consider any or all of the following actions: (a) filing a complaint against the auditor with AICPA, the appropriate State board of accountancy, or both; (b) recommending that HUD suspend or debar the auditor from further participation in Federal programs; or (c) referring the case to the U.S. Department of Justice for possible civil or criminal prosecution.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

1. What quality management (QM) standard applies a new, risk-based approach to customizing the firm's QM system?

   a. The GAS/SA Audit Guide.

   b. The HUD audit guide.

   c. SQMS No. 1.

   d. *Government Auditing Standards* (the Yellow Book).

2. What is one difference between the AICPA and Yellow Book independence requirements?

   a. The Yellow Book is not concerned about the performance of nonattest services.

   b. They have similar, but not identical, conceptual frameworks.

   c. The AICPA requires auditors to consider financial statement services as threats to independence.

   d. The Yellow Book requirements only apply to individuals who are considered covered members.

3. Emily and Richard, the senior members of a HUD engagement team, have been working on the same annual audit for the past 10 years. Which threat to their independence might exist?

   a. Bias threat.

   b. Familiarity threat.

   c. Self-review threat.

   d. Undue influence threat.

4. Which of the following is a condition that must be met for auditors to retain their independence when performing a nonaudit service during the financial statement period of a Yellow Book audit?

   a. They performed the service before the auditor's report was released.

   b. The financial statements for the period to which the nonaudit service relates were audited by the same auditor.

   c. The nonaudit service is prohibited by the Yellow Book.

   d. The service related only to periods prior to the financial statements.

5. According to the GAS/SA Audit Guide, which of the following statements applies to an auditor's responsibility for exercising professional judgment?

   a. The ability to make professional judgments is related to the auditor's competence.

   b. Professional judgment is related to a single auditor, not the whole team.

   c. Use of the conceptual framework removes the need for professional judgment in independence decisions.

   d. Administrative aspects such as staff assignments do not require professional judgment.

6. As stated beginning at Paragraph 4.09 of the Yellow Book, the work situation of which type of auditor is characterized by moderate levels of ambiguity, complexity, or uncertainty, requiring at least an intermediate level of proficiency?

   a. Nonsupervisory auditors.

   b. Supervisory auditors.

   c. Partners.

   d. Directors.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

1. What quality management (QM) standard applies a new, risk-based approach to customizing the firm's QM system? **(Page 267)**

   a. The GAS/SA Audit Guide. [This answer is incorrect. The AICPA Audit Guide, *Government Auditing Standards and Single Audits* (GAS/SA Audit Guide), presents guidance for financial statement audits performed under *Government Auditing Standards* and guidance for compliance audits conducted under the Single Audit Act and the Uniform Guidance. These are different considerations than guidance related to a firm's QM system.]

   b. The HUD audit guide. [This answer is incorrect. In addition to GAAS and the Yellow Book, audits of for-profit HUD entities must comply with the *Consolidated Audit Guide for Audits of HUD Programs* (the HUD audit guide) issued by the HUD Office of Inspector General (HUD OIG). However, this guidance is not specifically related to a firm's QM system.]

   c. **SQMS No. 1. [This answer is correct. SQMS No. 1 takes a new approach in addressing the firm's responsibility to design, implement, and operate a system of QM. The approach is risk-based and designed to improve scalability of the standards. It requires a firm to customize its system of QM based on the nature and circumstances of the firm and its engagements using an approach that considers the QM system as a whole, with a stronger focus on continual remediation and improvement.]**

   d. *Government Auditing Standards* (the Yellow Book). [This answer is incorrect. Paragraph 5.02 of the Yellow Book indicates that audit organizations conducting Yellow Book audits must establish and maintain a QC system that is designed to provide reasonable assurance that the organization and its personnel comply with professional standards and applicable legal and regulatory requirements. However, the requirements in the Yellow Book are specific to Yellow Book audits and not generally for the firm's entire QM system, as is the guidance described above.]

2. What is one difference between the AICPA and Yellow Book independence requirements? **(Page 269)**

   a. The Yellow Book is not concerned about the performance of nonattest services. [This answer is incorrect. One concern related to meeting independence requirements is the effect of providing nonattest services to the client. Both the AICPA and the Yellow Book include requirements about independence related to nonattest engagements.]

   b. **They have similar, but not identical, conceptual frameworks. [This answer is correct. The major differences between the independence requirements in the AICPA's *Code of Professional Conduct* (AICPA Code) and the Yellow Book relate to (1) when the conceptual framework for independence is used and (2) certain documentation requirements. Paragraph 2.36 of the GAS/SA Audit Guide states that the AICPA Code and the Yellow Book have similar, but not identical, conceptual frameworks for independence. The Yellow Book's conceptual framework is used to evaluate threats to independence when making decisions on conditions or activities that are not specifically prohibited by the Yellow Book. However, the AICPA's conceptual framework should be used when making decisions about independence matters that are not explicitly addressed in the AICPA Code.]**

   c. The AICPA requires auditors to consider financial statement services as threats to independence. [This answer is incorrect The AICPA Code does *not* require auditors to consider preparation of accounting records and financial statement services as services that create threats or significant threats to independence.]

   d. The Yellow Book requirements only apply to individuals who are considered covered members. [This answer is incorrect. Some of the AICPA independence rules (not the Yellow Book rules) apply a team approach, which narrows the pool of those members of a firm who are subject to certain independence requirements by focusing on *covered members*. Covered members include those who are (1) members of an attest engagement team; (2) able to influence the engagement or attest engagement team; (3) a partner, partner equivalent, or manager who provides 10 or more hours of nonattest services to the attest client within any fiscal year; (4) a partner or partner equivalent in the office in which the lead attest engagement partner or partner equivalent primarily practices in connection with the attest engagement; (5) the firm, including the firm's employee benefit plans; and (6) an entity whose operating, financial, or accounting policies can be controlled by any of items (1) to (5) or two or more of them acting together.]

3. Emily and Richard, the senior members of a HUD engagement team, have been working on the same annual audit for the past 10 years. Which threat to their independence might exist? **(Page 272)**

   a. Bias threat. [This answer is incorrect. This is the threat of the auditor taking a position that is not objective because of his or her political, ideological, social, or other convictions. The Yellow Book, Paragraph 3.40, provides examples of this threat, such as an engagement team member with strong preconceptions that could affect the auditor's objectivity about the objective of a program under audit. Based on the information in this scenario, Emily and Richard's independence is not affected by a bias threat.]

   b. **Familiarity threat. [This answer is correct. This is the threat that aspects of a relationship (such as a close or long relationship with the client) with the audited entity's management or other personnel will lead the auditor to take a position that is not objective. According to Paragraph 3.41 of the Yellow Book, one example of a familiarity threat is when senior members of the engagement team (like Emily and Richard) have a long association with the audited entity.]**

   c. Self-review threat. [This answer is incorrect. This is the threat that when making a judgment significant to a Yellow Book engagement, the auditor or audit organization will not appropriately evaluate judgments made or work performed as part of nonaudit services they previously provided. One of the examples provided in Paragraph 3.39 of the Yellow Book is issuing a report on the effectiveness of the operation of the financial or performance management system that the audit organization designed or implemented. The scenario above is not an example of the self-review threat.]

   d. Undue influence threat. [This answer is incorrect. This is the threat of external influences or pressures affecting the auditor's ability to make objective judgments. One example of this threat from Paragraph 3.42 of the Yellow Book is unreasonable pressure to reduce fees or to restrict time spent on an engagement. As there were no outside influences mentioned in this scenario, Emily and Richard are not facing this specific threat to their independence.]

4. Which of the following is a condition that must be met for auditors to retain their independence when performing a nonaudit service during the financial statement period of a Yellow Book audit? **(Page 279)**

   a. They performed the service before the auditor's report was released. [This answer is incorrect. If the nonaudit service was provided before the period of professional engagement, independence is not impaired, per Paragraph 3.67 of the Yellow Book. Performing the service during the period of professional engagement would impair independence, even if it was before the release of the auditor's report.]

   b. The financial statements for the period to which the nonaudit service relates were audited by the same auditor. [This answer is incorrect. If the financial statements for the period to which the nonaudit service relates were audited by *another auditor*, then the current auditor can retain independence under Paragraph 3.67 of the Yellow Book.]

   c. The nonaudit service is prohibited by the Yellow Book. [This answer is incorrect. The Yellow Book identifies specific nonaudit services that always impair independence. If that is the case, performing that nonaudit service will impair an auditor's independence for that Yellow Book audit.]

   d. **The service related only to periods prior to the financial statements. [This answer is correct. Paragraph 3.67 of the Yellow Book explains that a nonaudit service performed during the**

period covered by the financial statements might not impair the auditor's independence with respect to those financial statements if three conditions are met. One of those conditions is that the nonaudit service related only to periods prior to that of the financial statements.]

5. According to the GAS/SA Audit Guide, which of the following statements applies to an auditor's responsibility for exercising professional judgment? **(Page 282)**

   a. **The ability to make professional judgments is related to the auditor's competence. [This answer is correct. The GAS/SA Audit Guide, Paragraph 2.41, provides considerations relative to the exercise of professional judgment. According to that guidance, the use of professional knowledge, skills, and abilities to diligently gather information, in good faith and with integrity, and to objectively evaluate the sufficiency and appropriateness of evidence is a critical component of an audit. Professional judgment and competence are interrelated because judgments made are dependent upon the auditor's competence.]**

   b. Professional judgment is related to a single auditor, not the whole team. [This answer is incorrect. According to Paragraph 2.41 of the GAS/SA Audit Guide, professional judgment represents the application of the collective knowledge, skills, and abilities of all the personnel involved with an audit, as well as the professional judgment of individual auditors. Professional judgment may also involve collaboration with other stakeholders, specialists, and management in the audit organization.]

   c. Use of the conceptual framework removes the need for professional judgment in independence decisions. [This answer is incorrect. Per Paragraph 2.41 of the GAS/SA Audit Guide, the use of professional judgment is important when applying the conceptual framework to determine independence for a specific situation. This includes identifying and evaluating any threats to the auditor's independence, including threats to the appearance of independence, and related safeguards that may mitigate the identified threats.]

   d. Administrative aspects such as staff assignments do not require professional judgment. [This answer is incorrect. According to Paragraph 2.41 of the GAS/SA Audit Guide, the use of professional judgment is important in performing *all* aspects of auditors' professional responsibilities, including assigning competent staff to the audit and defining the scope of work.]

6. As stated beginning at Paragraph 4.09 of the Yellow Book, the work situation of which type of auditor is characterized by moderate levels of ambiguity, complexity, or uncertainty, requiring at least an intermediate level of proficiency? **(Page 286)**

   a. Nonsupervisory auditors. [This answer is incorrect. According to the Yellow Book, *nonsupervisory auditors* plan or perform engagement procedures. Their work situations are characterized by *low* levels of ambiguity, complexity, and uncertainty. The nonsupervisory auditor role necessitates at least a *basic* level of proficiency.]

   b. **Supervisory auditors. [This answer is correct. The Yellow Book states that the audit organization and engagement teams may consider the levels of proficiency needed for each role on the engagement when assigning auditors to the engagements. *Supervisory auditors* plan engagements, perform engagement procedures, or direct engagements. Work situations for these auditors are characterized by moderate levels of ambiguity, complexity, and uncertainty. The supervisory auditor role necessitates at least an intermediate level of proficiency.]**

   c. Partners. [This answer is incorrect. As discussed in the Yellow Book, *partners* plan engagements, perform engagement procedures, or direct or report on engagements. They also may review engagement quality prior to issuing reports, sign the report, or both. Their work situations are characterized by *high* levels of ambiguity, complexity, and uncertainty. The partner role necessitates an *advanced* level of proficiency.]

   d. Directors. [This answer is incorrect. Per the Yellow Book, *directors* must have an *advanced* level of proficiency because their work situations are characterized by *high* levels of ambiguity, complexity, and uncertainty.]

CLIENT ACCEPTANCE AND CONTINUANCE DECISIONS

The auditor's broad responsibilities under professional standards regarding client acceptance and continuance decisions are as follows:

- *Establishing Policies and Procedures:*
  - SQMS No. 1 (QM 10A.27) indicates the CPA firm should establish policies and procedures for accepting and continuing client relationships and specific engagements. Engagement should only be continued or accepted when the firm:
    - has the necessary competencies to perform the engagement and has the capabilities, including time and resources, to do so;
    - can comply with legal and relevant ethical requirements; and
    - has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity.
  - *Government Auditing Standards*, requires audit firms to include policies and procedures in their systems of quality control that are designed to provide reasonable assurance that the firm will accept or continue an audit engagement only if it can comply with professional standards, ethical principles, legal requirements, and can act within its legal mandate or authority.
- *Timing of Procedures.* AU-C 300.06 and AU-C 300.A8 indicate that auditors perform client acceptance and continuance procedures, including evaluating compliance with ethical requirements, prior to performing significant audit activities for the current engagement.
- *Communicating with Previous Auditors.* According to AU-C 210A.11, the successor auditor should request permission from the prospective client to inquire of the predecessor auditor prior to final acceptance of the engagement, about matters that would assist in making the acceptance decision. In determining whether to accept the engagement, the auditor should evaluate the predecessor auditor's response or consider the implications if the predecessor auditor provides no response or a limited response.
- *Establishing Preconditions for an Audit.* AU-C 210A addresses the auditor's responsibilities in agreeing on the terms of an audit which includes establishing that certain preconditions are present. As a precondition for an audit, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. Another precondition of an audit is to obtain the agreement of management and those charged with governance, as appropriate, that it acknowledges and understands its responsibilities (AU-C 210A.06). If the preconditions for an audit are not met, the auditor should discuss the matter with management. Unless the auditor is required by law or regulation to accept the engagement, the auditor should not accept the proposed audit engagement. (AU-C 210A.08)

Client acceptance/continuance policies and procedures provide reasonable assurance that:

- Engagements that are accepted can reasonably be expected to be completed with professional competence.
- The risks associated with providing professional services in the particular circumstances are appropriately considered.

Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement, but the information gathered also generally affects later steps in the audit process for those clients or engagements that are accepted. For example, acceptance/continuance procedures often provide critical information that can be used by the auditor when establishing an audit strategy, identifying and assessing risks, and developing a detailed audit plan, as well as for other audit purposes. AU-C 500 notes that audit evidence includes information obtained from client acceptance and continuance procedures.

If issues involving the acceptance or continuance of a client relationship or a specific engagement are identified and the firm decides to accept or continue the client relationship or the specific engagement, SQCS No. 8 (QM 10A.28) requires the firm to consider whether any ethical requirements under ET 1.110.010. *Conflicts of Interest* interpretation, of the *Integrity and Objectivity Rule*, at ET 1.100.001, of the AICPA *Code of Professional Conduct* apply and to document how any issues were resolved.

Preconditions for an Audit

Financial Reporting Framework. As a precondition for an audit, the auditor should determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable. The applicable financial reporting framework is the set of accounting principles used by the entity to prepare its financial statements. (This course assumes that entities are following GAAP.) According to AU-C 210A.A4, factors to consider when determining whether the financial reporting framework is acceptable include—

- The nature of the entity.
- The purpose of the financial statements (for example, whether they meet the common financial information needs of a wide range of users).
- The nature of the financial statements (for example, whether they are a complete set of financial statements or a single financial statement).
- Whether law or regulation prescribes the applicable financial reporting framework.

The determination generally is made during the acceptance and continuance procedures. An auditor may presume that the applicable financial reporting framework is acceptable in circumstances in which the framework has been recognized as such by a relevant authoritative body. Such authoritative recognition exists in the Council of the AICPA's designation of sources of established accounting principles pursuant to the Accounting Principles Rule (ET 1.320.001) of the AICPA *Code of Professional Conduct* and special-purpose accounting frameworks as described in AU-C 800, *Special Considerations—Audits of Financial Statements Prepared in Accordance with Special-Purpose Frameworks*, as identified in AU-C 210A.A3 and A6–.A8.

Agreement of Management. Another precondition for an audit is to obtain the agreement of management that they acknowledge and understand their responsibilities. The agreement generally is obtained through the use of an engagement letter.

Management-imposed Scope Limitation. There may be circumstances when management or those charged with governance may impose a limitation on the scope of the auditor's work. AU-C 210A.07 notes that if the auditor believes that the scope limitation would result in a disclaimer of opinion on the financial statements as a whole, the auditor should not accept the engagement. However, if the entity is required by law or regulation to have an audit and the scope limitation and disclaimer of opinion are acceptable under the applicable law or regulation, the auditor may, but is not required, to accept the engagement.

Risk-based Perspective

When deciding whether to accept or continue a client, the auditor considers the risks related to the engagement. This is a very high-level consideration of whether the risk level related to the engagement and the overall financial statements is greater than normal. For situations that pose greater than normal risk, firm policies determine when a new engagement is declined and when the relationship with a continuing client is terminated. If a client with greater than normal risk is accepted or continued, there has to be an appropriate audit response to the risk level in the audit plan. A client with greater than normal risk poses a greater risk to the auditor from a business risk perspective (the auditor's own business risk) and also involves a greater risk of material misstatement of the financial statements. AU-C 240.A27 and AU-C 315A.07 note that the auditor considers whether procedures relating to the acceptance and continuance of clients and engagements may be relevant in the identification of risks of material misstatement.

For a new HUD audit engagement, the auditor obtains a general understanding of management's reputation and integrity, of HUD and HUD-assisted multifamily housing projects, and the entity's operations and financial condition through discussions with management, predecessor auditors, and other knowledgeable parties. For a continuing engagement, the auditor considers the same factors, but also considers whether there have been changes that affect the auditor's continuance decision.

The engagement acceptance or continuance decision normally focuses on factors that increase overall financial statement risk. What is the intended use of the financial statements? Will they be used for other purposes in addition to HUD or OMB audit requirements? For example, does the entity need audited financial statements to comply with the requirements of a mortgage or loan agreement? Do discussions with the predecessor auditor, bankers, insurance carriers, attorneys, or others raise any concerns about management integrity? Are there increased risks due to indications of pressures, opportunities, or incentives for fraudulent financial reporting on the part of management? Is the project in a precarious financial position that creates a likelihood of loan default or noncompliance with the HUD Regulatory Agreement? Consideration of this information might cause the auditor to decline to accept the engagement or to terminate the client relationship, or might cause the auditor to plan and perform the audit in a different manner.

The early identification of higher risk engagements can help ensure that audit personnel with adequate Yellow Book, HUD, and overall audit experience are assigned to the engagement and that sufficient involvement of the partner and manager occur at all stages of the audit, but particularly during the risk assessment process. (This early identification of risks and the associated assignment of appropriate engagement team members helps meet the requirement in AU-C 220A.16 that the audit partner needs to be satisfied that the engagement team and any auditor's external specialists have the appropriate competencies for the engagement.) Also, the preliminary scheduling of audit work and estimates of audit time (and often, fee estimates) will be affected by any risks that have been identified through client acceptance or continuance. In addition, the reporting deadlines established need to allow sufficient time for dealing with the anticipated risk level. In some cases, greater than normal involvement of a second partner in the engagement may be advisable. Many of these matters are audit strategy issues.

Before deciding to propose for or accept a new HUD audit engagement, the auditor considers his or her ability to accept the engagement, management's integrity, and the scope of the proposed audit. These considerations should also be made annually in deciding whether to retain an existing client.

Ability to Accept the Engagement

An auditor should not propose for, or accept, an audit engagement unless he or she will be able to meet the responsibilities and requirements related to the engagement. Factors to be considered include the following:

- Auditor independence.
- Expertise in the multifamily housing industry and HUD and its programs or ability to obtain sufficient knowledge to meet professional standards.
- Ability to meet HUD filing requirements and deadlines.
- Ability to meet HUD and government audit requirements.

Prospective Client's Reputation

An auditor considers the reputation of the prospective client, its management, and those charged with governance. Quality control standards require CPA firms to establish policies and procedures to minimize the likelihood of accepting or continuing association with a client whose management lacks integrity. The auditor ought to carefully evaluate any adverse information about management and consider whether the CPA firm would not want to be associated with the entity's financial statements. The auditor's concern is with the client's general honesty, good faith, and forthrightness in its operations, administration, and financial reporting and in providing information, responses, and representations for the audit. Consideration may also be given to whether—

- Management and those charged with governance are knowledgeable about the entity's operations.
- Management and those charged with governance are committed to the application of appropriate accounting principles.

- The entity possesses an appropriate organizational structure, including consideration of the nature and purpose of related party relationships.
- Management and those charged with governance have an appropriate attitude about the financial reporting process, including internal controls.
- Management and those charged with governance reflect an appropriate attitude regarding the general nature of audit procedures to be applied, time commitments and client resources, and level of effort necessary to complete the audit.

In connection with the auditor's initial or recurring retention, the auditor might discuss or correspond with management about a significant issue, for example, particular application of an accounting principle or auditing standard, or prior audit findings. Unless all governance members are involved in managing the entity, AU-C 260.14 indicates that significant findings or issues arising during the audit that were discussed or were the subject of correspondence with management should be communicated to those charged with governance.

Neither quality control standards nor GAAS provide specific requirements on the depth of investigation of a prospective client, except for the requirement in AU-C 300.13 to communicate with a predecessor auditor. For purposes of assessing a client's reputation, the authors suggest the following as sources from which the auditor would normally obtain information:

- Other CPAs and professionals in the community who serve the client; e.g., attorneys, bankers, and investment advisors.
- Published accounts of the entity's activities and problems in the news media.
- The prospective client's most recent financial statements and other information released to the public or filed with regulatory agencies and made a matter of public record.
- Oversight entities (e.g., HUD).
- The predecessor auditor. If the prospective client is well-known to the auditor, the only contact may be with the predecessor auditor.

Level of Service

Information about the entity and the level of service being requested is vital in deciding whether to propose for the engagement, in preparing a proposal and reasonable fee estimate once a decision is made to do so, and in planning the engagement once it is obtained. Additional procedures ought to be performed if a project owner requests a level of service lower than one required by an agreement, such as a loan agreement. If, based on those procedures, auditors believe the lower level of service is acceptable, the authors recommend that the auditors document the results of those procedures in their working papers and address the issue in their engagement letter.

Use of Third-party Service Providers

Audit firms frequently subcontract portions of their work to third-party service providers, including other firms or individual auditors. Third-party service providers are entities that are not controlled by the member or member's firm and individuals not employed by the member or member's firm. Independent contractors used by a CPA meet the definition of third-party service providers.

ET 1.150.040 requires that clients be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. If the audit firm intends to use a third-party service provider, to perform portions of the audit, the client should be informed before confidential information is shared with the service provider. If the client objects, the auditor should perform the services without using the third party or should decline the engagement. ET 1.150.040 applies when another party is used, for example, to audit an element, account, or item of the financial statements, to observe inventory, or to act as a specialist. The authors believe the ruling does not apply when another audit firm performs a separate engagement, the results of which will be used by the auditor, for example, when another firm audits a component unit. In addition, the client is not required to be informed when a third party is used only for the auditor's administrative support services, such as for record storage, software application hosting, or authorized e-file tax transmittal services. ET 1.700.040 requires a contractual agreement between the audit firm and the service provider to maintain the confidentiality of client information. This rule also requires members to be reasonably assured that the service provider has procedures in place to prevent the unauthorized release of confidential information.

Using the Work of Another Auditor

AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*, provides guidance for when another auditor audits a component that is included in the financial statements audited by the group auditor. Group financial statements may include a consolidation or combination of subsidiaries or other entities, but they can also encompass the aggregate financial information of other organizational structures, such as branches, divisions, or geographical locations.

According to AU-C 600.11, *group audits* are audits of *group financial statements*, which are financial statements that include the financial information of more than one component. A *component* is any entity or business activity for which group or component management prepares financial information that is required by accounting standards to be included in the group financial statements. A *component auditor* is an auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit. Component auditors are not just other auditors. A component auditor may be part of the group engagement partner's firm, a network firm of the group auditor, or another firm.

Lesson 3 provides a discussion of AU-C 600, including considerations in audits of HUD-assisted entities and applicability of AU-C 600 to an audit of compliance.

DOCUMENTING THE AUDITOR'S ENGAGEMENT ACCEPTANCE OR CONTINUANCE DECISION

Before accepting an engagement, some firms find it useful to complete checklists that summarize relevant considerations. The authors recommend that the firm formally document the acceptance decision-making process. In addition, AU-C 220A.25 requires the auditor to document (a) issues identified concerning compliance with relevant ethical requirements and how they were resolved, (b) conclusions on compliance with applicable independence requirements and any relevant discussions with the firm supporting those conclusions, and (c) conclusions reached about the acceptance and continuance of the client relationship and engagement. Information gathered in the client acceptance process is considered when identifying risks that could result in material misstatement of the financial statements. Therefore, when performing client acceptance (and continuance) procedures, the auditor is alert for risks that could result in misstatements at the financial statement level and at the relevant assertion level for classes of transactions, account balances, and disclosures.

Information about the entity's operations, organization, audit risk factors, and internal control should be documented. Much of this information will be obtained during later planning stages, but the auditor should document any of the information identified during the pre-engagement and early planning stages.

Annual Evaluation for Continuing Engagement

The annual evaluation of clients and engagements generally is performed as part of the planning process for continuing engagements. The auditor may consider the topics discussed in this course and reassess the desire and ability to retain the engagement. This reassessment is especially important if there has been a high degree of turnover in key management positions. Other reasons to reevaluate whether to continue serving the client include significant changes in ownership of the project, financial condition, litigation status, compliance with HUD requirements, scope of the engagement, or other considerations that would have caused the auditor to reject the client had the conditions existed at the time of the original acceptance. Moreover, general economic conditions, industry risk factors, and other considerations may have changed since the initial client acceptance decision. The assessment also considers matters such as (a) being aware of potential legal liability risks, (b) avoiding conflict of interest problems, and (c) monitoring compliance with independence rules. The downturn in the economy and related risks resulting from COVID-19 may have resulted in dramatic changes since the initial acceptance decision. An auditor needs to make the difficult judgments about how to respond to such changes.

If the firm obtains information that would have caused it to decline an engagement, had that information been available previously, SQCS No. 8 (QM 10A.30) notes that policies and procedures on continuance of the engagement and the client relationship should include consideration of the professional and legal responsibilities that apply to the circumstances, and the possibility of withdrawing from the engagement or from both the engagement and the client relationship. For those engagements that will be continued, auditors consider whether their engagement continuance procedures provide information that may be relevant in identifying risks of material misstatement due to error or fraud, as discussed in Lesson 3.

Once a client relationship has been established, the firm has more objective information to use in evaluating and reassessing the conclusions reached for each factor considered when the initial client acceptance decision was made. The review of factors affecting the continuance decision is made in light of the increased knowledge about the client obtained from the prior audit(s) and consideration of changes that have occurred since the prior audit. This review generally is performed at the beginning of an engagement to ensure that no circumstances have occurred since the last engagement that would cause the firm to discontinue providing services to the client. A decision to discontinue services to a client generally is made before work commences on the engagement.

The continuance decision should be documented by signing off the appropriate program steps in a general planning procedures practice aid. The sign-off generally is done during the planning stage of the current year engagement. These steps may instruct the auditor to complete or update an engagement acceptance and continuance form, which will help satisfy the professional requirements related to acceptance and continuance of client relationships and specific engagements.

ESTABLISHING THE TERMS OF THE HUD AUDIT ENGAGEMENT

After a new or continuing engagement has been accepted, AU-C 210A.09–.10 states that the auditor should agree upon the terms of the audit engagement with management or those charged with governance, as appropriate, and document that agreement in an audit engagement letter or another form of written communication. In addition, the Yellow Book requires the auditor to establish an understanding with the client about the services to be performed for each engagement and to document that understanding through a written engagement letter. As discussed later in this section, Paragraph 1-5(A) of the HUD audit guide also requires the auditor to establish a written understanding about the engagement.

AU-C 210A.10 indicates that the engagement letter should include the following:

- The objective and scope of the engagement.
- Management's responsibilities.
- The auditor's responsibilities.
- A statement that, due to the inherent limitations of an audit combined with the inherent limitations of internal control, there is a risk that a material misstatement may not be detected.
- Identification of the applicable financial reporting framework.
- Reference to the expected form and content of reports to be issued by the auditor and a statement that circumstances may occur in which a report may differ from its expected form and content.

As previously discussed, one of the preconditions for an audit is to obtain the agreement of management that they acknowledge and understand their responsibilities. That agreement generally is obtained through the use of an engagement letter.

AU-C 210A.09 states that auditors should agree upon the terms of the engagement with management or those charged with governance, as appropriate. Depending on the structure of the entity, the engagement letter may be addressed to management, those charged with governance, or both. However, because one of the preconditions for an audit is to obtain agreement from management that it acknowledges and understands its responsibilities, the authors believe management should always be included. In addition, AU-C 260 states the auditor should communicate with those charged with governance the auditor's responsibilities with regard to the audit and the planned scope and timing of the audit, as well as the significant risks identified by the auditor. Those items can be communicated through an engagement letter or separate communication. In most cases, the authors believe the items are communicated through an engagement letter. Therefore, to accomplish all of the previously discussed objectives, the authors recommend that the engagement letter be addressed to, and signed by, both management and those charged with governance. If there is no separate group charged with governance, then the letter would only be addressed to, and signed by, management. The auditor may choose to communicate with those charged with governance in a separate communication.

If applicable, the understanding includes whether the auditor will make use of a specialist (for example, an appraiser) or another auditor's report on a service organization. However, determining the need to obtain a service auditor's report involves considerations that may have to wait until the audit planning stage when the auditor has more information about the significance of the service organization's controls to the entity's controls. Thus, it may not be possible to reach a definitive understanding about these matters with the client at the pre-engagement stage, and the auditor may need to alert the client of this. As discussed in Lesson 2, AU-C 402, *Audit Considerations Relating to an Entity Using a Service Organization*, provides guidance for auditors when the entity they are auditing uses a service organization. It is a best practice to request a service auditor's report on aspects of a service organization's controls relevant to the entity's internal control or to the services provided for the entity.

In addition to documenting the required matters mentioned in the preceding paragraphs, an engagement letter can be used to document the fee estimate, expected timing of fieldwork and the report delivery date, expected client clerical assistance during the audit, and arrangements with predecessor auditors, if applicable. Documenting such matters can help prevent misunderstandings. Also, an engagement letter can be an efficient way to provide audit staff with an understanding of the engagement arrangements.

Considerations for Compliance Audits

AU-C 935.38 states that in a compliance audit, the auditor should communicate the following to those charged with governance, which may also be included within the engagement letter:

- The auditor's responsibilities under GAAS, *Government Auditing Standards*, and the governmental audit requirement, such as the HUD audit guide or the Uniform Guidance.
- An overview of the planned scope and timing of the compliance audit.

Government Auditing Standards **Requirements.** The Yellow Book broadens the parties with whom auditors should communicate and specifies the communication of specific information during the planning stage of a financial audit. These requirements are intended to reduce the risk that the needs or expectations of the parties involved may be misinterpreted. The communications specified by *Government Auditing Standards* are discussed in the following paragraphs.

When performing a Yellow Book audit (such as a HUD audit), Paragraph 6.06 of the Yellow Book states that in addition to the AICPA requirements, the auditor should communicate pertinent information that in his or her professional judgment needs to be communicated to persons contracting for or requesting the audit, and to cognizant legislative committees when the audit is performed pursuant to a law or regulation or when the auditor conducts the work for a legislative committee responsible for overseeing the entity. Where there is not a single person or group responsible for overseeing strategic direction and fulfillment of the entity's accountability obligations, or where the identity of those charged with governance is not clearly evident, the auditor should document the process followed and conclusions reached when identifying the appropriate individuals with whom to communicate.

The Yellow Book states that auditors should clarify report distribution responsibilities with the auditee. Paragraph 6.70(b) of the Yellow Book indicates that if the auditor is to be responsible for report distribution, the auditor should reach agreement with the party contracting for the audit about which officials or organizations will receive the report and the steps being taken to make the report publicly available. The authors recommend this clarification be included in the engagement letter.

The Yellow Book indicates that *Government Auditing Standards* do not apply to professional services other than audits or attestation engagements and would not be reported as having been conducted in accordance with such standards. The Yellow Book extends *Government Auditing Standards* to review engagements. However, when the auditor performs nonaudit services for an entity for which it also performs audit services under *Government Auditing Standards*, the auditor should communicate with the entity to clarify that the nonaudit services do not constitute an audit under *Government Auditing Standards*.

HUD Audit Guide Requirements. The HUD audit guide at Paragraph 1-5(A) states that the engagement letter must include the following mandatory information:

a. A statement that the audit is to be performed in accordance with generally accepted auditing standards, *Government Auditing Standards*, and the current version of HUD's audit guide, HUD Handbook 2000.4.

b. The estimated date the audit report will be delivered to the audited entity.

c. A statement that the auditor is required to provide the HUD Secretary or his or her designee, the HUD Inspector General, the Government Accountability Office (GAO), or their representatives access to audit documentation or any other documents needed for their review of the audit. As noted in the HUD audit guide, Paragraph 1-5(A), documentation includes hard copy and electronic form, and "access to audit documentation" includes making necessary photocopies of hard copy audit documentation or other documents and electronic copies of electronic audit documentation.

d. A statement that if the auditor becomes aware of noncompliance with provisions of laws, regulations, contracts, and grant agreements or fraud that has occurred or is likely to occur, the auditor is required to bring such acts to the attention of the appropriate level of management. In addition, the auditor may be required to contact the HUD OIG single audit coordinator to discuss matters relating to fraud or equity skimming. Based on that discussion, the auditor may be requested to prepare a written report on all known or likely fraud that has occurred. Acceptance of the engagement letter grants the auditor permission to contact the HUD OIG single audit coordinator and discuss the conditions noted.

e. A statement that if the program being audited requires electronic submission of the financial and compliance data to HUD, (1) the auditee is responsible to make the electronic submission to HUD, and (2) the auditor is responsible, under a separate agreed-upon procedure engagement, to apply procedures to ensure that the data submitted agree with the auditee's hard copies of the supporting documentation.

f. A description of the scope of the planned audit and contents of the report(s).

g. If there was a predecessor auditor, statements that the auditee grants permission for the successor auditor to discuss and review the prior auditor's audit documentation, and that the auditee is to make the appropriate arrangements. (Normally, before issuing an engagement letter, the auditor will contact the predecessor auditor to review audit documentation supporting the prior financial statement audit and any findings included in the predecessor auditor's compliance report. The auditor may also need to discuss with the predecessor auditor matters that are not adequately explained or documented in the audit documentation or a preexisting condition the auditor notes in his or her review that was not in the prior audit report. If the predecessor auditor refuses to allow the successor auditor access to that information or to discuss such matters, the successor auditor should include in the engagement letter that the auditee grants permission for the successor auditor to discuss and review the prior audit documentation and for the auditee to make the appropriate arrangements.)

h. A list of the information the auditor wants the client to provide and the requested delivery date of those items.

Electronic Submission. The project owner is responsible for ensuring that the electronic submission of required annual financial statement, audit, and other financial information to HUD's Real Estate Assessment Center (REAC) is complete, accurate, and timely, in accordance with the project owner's regulatory and contractual obligations to HUD. However, the project owner may engage others to input the financial information into the FASSUB template. If the auditor is engaged to perform this service, language to that effect can be included in the engagement letter.

To ensure that the data submitted to REAC by the project owner agrees with the information contained in the hard copy audit report, HUD requires that a CPA perform an agreed-upon procedure engagement prior to the electronic submission of the HUD entity's financial information. The engagement may be performed by the auditor or another CPA. Because the agreed-upon procedure engagement is performed in accordance with the Statements on Standards for Attestation Engagements (SSAEs) rather than GAAS, the CPA typically obtains a separate engagement letter for this service.

Audit Fee Considerations. The following is a summary of HUD's current guidelines:

- Project owners should use competitive bidding processes when obtaining audit services. The extent of bidding activity varies from project to project—from simple telephone bidding of at least three auditors to formal requests for proposal.
- Project owners are not required to seek HUD's review of bids submitted by auditors.
- Audit fees are allowable project costs, that is, they can be paid for out of project funds.

Management Agent Considerations. The partners or board of directors may engage a management agent to provide various services, including bookkeeping and accounting services. Auditors should give careful consideration to how the use of a management agent will affect the planning and performance of the audit. In general, the management agent should be viewed as an extension of the project owner. Thus, auditors will need to consider the reputation and integrity of the management of the management agent as part of the client acceptance and retention process. The auditors will also need to consider whether the management agent's accounting system will allow the application of audit procedures sufficient to express an opinion. The management agent should also be requested to sign the engagement letter. The project owner's use of a management agent will have a significant effect on the auditors' approach to obtaining an understanding of internal control, as discussed in Lesson 2.

Indemnification Clauses

In some instances, entities have issued RFPs or asked auditors to sign contracts containing clauses indemnifying the client against damages, losses, or costs arising from lawsuits, claims, or settlements that relate, directly or indirectly, to the attest client's acts. Because such clauses are often included in RFPs and proposed audit contracts, auditors should carefully review those documents to ensure that they are not agreeing to such provisions. ET 1.228.020, *Indemnification of an Attest Client* states that such an agreement would impair the auditor's independence. On the other hand, according to ET 1.228.010, *Indemnification of a Covered Member*, the engagement letter may include a clause that provides that the attest client would release, indemnify, defend, and hold the covered member (and the covered member's partners, heirs, executors, personal representatives, successors, and assigns) harmless from any liability and costs resulting from knowing misrepresentations by management. Such a clause would not impair the auditor's independence.

Some CPA firms attempt to reduce the cost of an adverse malpractice finding by including provisions in their engagement letters. Examples of such provisions include:

- A limitation on the damages a firm may have to pay for negligent errors or omissions.
- A release from liability if the firm fails to detect misstatements in the financial statements as a result of knowing misrepresentations made by management.
- Indemnification by the client for amounts the firm may have to pay to third parties if misstatements are not detected as a result of knowing misstatements made by management.

ET 1.228.010 states that such clauses do not impair a firm's independence.

ET 1.400.060 states that some regulators prohibit the use of indemnification and limitation of liability provisions in agreements for the performance of audit or other attest services, or provide that the existence of such provisions disqualifies a member from rendering such services to these entities. Entering into, or knowingly permitting another individual to enter into, such agreements with a client that is subject to the regulators' requirements would be considered an act discreditable to the profession. Further, use of a prohibited clause in an engagement letter could result in fines and other penalties by the regulator and result in an adverse finding in a liability action by a third party. The authors recommend that auditors consult with their legal counsel and insurance carriers when assessing such language in the engagement letter.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

7. Which of the following statements best describes an aspect of the client acceptance and continuance process?

   a. Information gathered during client acceptance and continuance is not considered appropriate audit evidence.

   b. If the auditor will use third-party service providers for a portion of the engagement, the client must be informed prior to engagement acceptance.

   c. The auditor's consideration of risks in relation to engagement acceptance and continuance is done at a very detailed level and takes a lot of time.

   d. Additional procedures should be performed if the potential client requests a lower level of service than the one required by an agreement.

8. According to the HUD audit guide, which of the following information must be included in an engagement letter?

   a. A statement that the audit will be performed under either the HUD audit guide or the Yellow Book.

   b. The estimated date that the audit report will be provided to the audit client.

   c. A statement that the audit documentation is confidential and will only be provided to the client.

   d. A statement that the auditor is prohibited to contact the HUD OIG to discuss or report any fraud discovered.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

7. Which of the following statements best describes an aspect of the client acceptance and continuance process? **(Page 297)**

   a. Information gathered during client acceptance and continuance is not considered appropriate audit evidence. [This answer is incorrect. Many auditors have traditionally viewed the client acceptance/continuance process as a means of gathering information that will allow a decision about whether to accept or continue a client relationship or a specific engagement, but the information gathered also generally affects later steps in the audit process for those clients or engagements that are accepted. AU-C 500 notes that audit evidence includes information obtained from client acceptance and continuance procedures.]

   b. If the auditor will use third-party service providers for a portion of the engagement, the client must be informed prior to engagement acceptance. [This answer is incorrect. ET 1.150.040 requires that clients be informed, preferably in writing, if the audit firm will outsource professional services to a third-party service provider. The client should be informed before confidential information is shared with the service provider, but this communication does not have to be made prior to engagement acceptance.]

   c. The auditor's consideration of risks in relation to engagement acceptance and continuance is done at a very detailed level and takes a lot of time. [This answer is incorrect. When deciding whether or not to accept or continue a client, the auditor considers the risks related to the engagement. This is a very *high-level* (not detailed) consideration of whether the risk level related to the engagement and the overall financial statements is greater than normal.]

   d. **Additional procedures should be performed if the potential client requests a lower level of service than the one required by an agreement. [This answer is correct. Information about the entity and the level of service being requested is vital in deciding whether to propose for the engagement, in preparing a proposal and reasonable fee estimate once a decision is made to do so, and in planning the engagement once it is obtained. Additional procedures ought to be performed if a project owner requests a level of service lower than one required by an agreement, such as a loan agreement. If, based on those procedures, the auditors believe the lower level of service is acceptable, this course recommends documenting the results of those procedures in the workpapers and addressing the issue in the engagement letter.]**

8. According to the HUD audit guide, which of the following information must be included in an engagement letter? **(Page 301)**

   a. A statement that the audit will be performed under either the HUD audit guide or the Yellow Book. [This answer is incorrect. At Paragraph 1-5(A), the HUD audit guide states that the engagement letter must include a statement that the audit is to be performed in accordance with GAAS, the Yellow Book, and the current version of the HUD's audit guide, HUD Handbook 2000.4.]

   b. **The estimated date that the audit report will be provided to the audit client. [This answer is correct. The HUD audit guide at Paragraph 1-5(A) states that the engagement letter must include certain mandatory information. One such piece of information is the estimated date the audit report will be delivered to the audited entity.]**

   c. A statement that the audit documentation is confidential and will only be provided to the client. [This answer is incorrect. Per Paragraph 1-5(A) of the HUD audit guide, the engagement letter must include a statement that the auditor is required to provide the HUD Secretary or his or her designee, the HUD Inspector General, the GAO, or their representatives access to audit documentation or any other documents needed for their review of the audit.]

d. A statement that the auditor is prohibited to contact the HUD OIG to discuss or report any fraud discovered. [This answer is incorrect. As discussed in Paragraph 1-5(A) of the HUD audit guide, the auditor may be required to contact the HUD OIG single audit coordinator to discuss matters relating to fraud or equity skimming. Based on that discussion, the auditor may be requested to prepare a written report on all known or likely fraud that has occurred. Acceptance of the engagement letter grants the auditor permission to contact the HUD OIG; it does not prohibit such contact.]

PLANNING A HUD AUDIT

Nature of Audit Planning

Planning an audit, according to AU-C 300.02, involves establishing the overall strategy for the engagement and developing an audit plan. Audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope, timing, and direction. It includes matters such as identifying material account balances, identifying audit areas with a higher risk of material misstatement, the overall responses to those higher risks, and the planned audit approach by area (for example, substantive procedures or a combined approach of substantive procedures and tests of controls).

Auditors generally establish a preliminary audit strategy before performing extensive risk assessment procedures based on knowledge from past experience with the client and the results of preliminary engagement activities. As auditors gather additional information through the performance of risk assessment procedures, they complete the overall audit strategy, including overall responses at the financial statement level.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential part of planning the audit. An effectively planned audit is responsive to the assessment of the risk of material misstatement and noncompliance based on the auditors' understanding of the entity and its environment, including its internal control.

Audit planning also includes developing an audit plan (also called an audit program). The audit plan is more detailed than the audit strategy and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence. The nature, timing, and extent of audit planning varies with the type of entity, the size and complexity of the entity, the auditor's experience with the entity, and the auditor's understanding of the entity and its environment, including internal control. However, audit planning always includes a risk assessment process.

COVID-19 Planning Considerations. COVID-19 has disrupted most aspects of life around the world, and has many implications for auditing, including significant considerations in the planning and risk assessment phase of an audit. To help auditors identify and address those implications for the audit, the authors recommend reviewing a list of factors to consider related to the COVID-19 pandemic when identifying risks that could result in a material misstatement of the financial statements and planning the audit response.

Requesting Information from the Client. Paragraph 1-5(A) of the *Consolidated Audit Guide for Audits of HUD Programs* (HUD audit guide) requires the auditor to provide a list of information he or she wants the auditee to provide for the audit, and the requested delivery date, in the engagement letter.

Risk Assessment Process

The risk assessment process involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on that understanding. The authors believe it is useful to classify the requirements related to audit planning in the following categories:

- Procedures performed.
- Understanding obtained.
- Decisions and judgments made.

Procedures Performed. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, such as preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team. The auditor performs all of these procedures when planning the audit. The auditor's consideration of fraud in accordance with AU-C 240 is not separate from the consideration of audit risk but is integrated into the overall risk assessment process. That is, the assessment of risks due to error occurs simultaneously with the assessment of risks due to fraud. AU-C 240 was made applicable to the compliance portion of a HUD audit by AU-C 935. AU-C 935 requires auditors to use professional judgment to adapt and apply GAAS to a compliance audit. The key requirements of AU-C 240 and AU-C 935 are addressed at relevant points throughout this course. Fraud considerations are discussed in Lesson 2.

Understanding Obtained. Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels. Components of that understanding are discussed in Lesson 2. AU-C 935.15 extends the requirement to perform risk assessment procedures to a compliance audit. It states that the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and internal control over compliance for each of the programs and compliance requirements selected for testing.

AU-C 315A.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315A.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information. AU-C 315A.A15–.A16 explains that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.

Some HUD entities maintain their project accounting records on a cash or modified cash basis during the year. (If that is the case, the financial records should be adjusted to the accrual basis at year end to prepare financial statements.) Thus, performing a preliminary analytical review by comparing the prior year's audited financial statements to the current year's general ledger may have no meaning. Before performing the analysis, the auditor may need to estimate the adjustments needed to prepare GAAP-based financial statements.

Decisions and Judgments Made. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement and material noncompliance. In a HUD audit, the auditor considers audit risks of misstatement and noncompliance with the applicable materiality judgments to determine the nature, timing, and extent of audit procedures and evaluate the results of the procedures performed.

Risk Assessment Procedures

AU-C 315A.05 explains that the auditor should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at both the financial statement and relevant assertion levels. Risk assessment procedures are focused toward gathering and evaluating information about the client and are not specifically designed as tests of controls or substantive procedures. Risk assessment procedures alone do not provide sufficient appropriate audit evidence on which to base an opinion. In all circumstances, further audit procedures are necessary to support an opinion.

AU-C 935.15 also establishes a requirement to perform risk assessment procedures for the compliance audit. It states that the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and internal control over compliance for each of the programs and compliance requirements selected for testing. In an audit of a for-profit HUD-assisted multifamily project, the applicable compliance requirements are contained in Chapter 3 of the HUD audit guide. Auditors of nonprofit project owners should use the OMB Compliance Supplement to determine applicable compliance requirements for testing. AU-C 935.A13 explains that the nature and extent of risk assessment procedures may vary for different entities and are influenced by factors such as the following:

- The newness and complexity of the applicable compliance requirements.
- The nature of the applicable compliance requirements.
- The auditor's knowledge of the entity's internal control over compliance with the applicable compliance requirements obtained in previous audits or other engagements.
- The services provided by the entity and how external factors affect the services.

- The amount of oversight by the grantor or pass-through entity.
- The ways management addresses findings.

Obtaining an understanding of the entity and its environment, including its internal control, is an essential aspect of the consideration of risk. Thus, audit procedures performed to obtain that understanding are referred to as *risk assessment procedures* because some of the information obtained by performing those procedures is used to support the auditor's assessment of the risks of material misstatement and noncompliance. Auditors normally consider the effectiveness of various types of risk assessment procedures in identifying risks during the planning process. A variety of risk assessment procedures are used when obtaining an understanding of the entity and its environment.

In the financial statement audit of a HUD engagement, under both GAAS and *Government Auditing Standards*, the auditor is responsible for obtaining reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by error or fraud. AU-C 250.A10 indicates that the auditor's responsibility for detecting misstatements resulting from violations of laws and regulations that have a direct and material effect on the financial statement amounts and disclosures is the same as that for misstatements caused by errors and fraud. In addition, the auditor is required to perform specific procedures to identify potential noncompliance with laws and regulations that may have a material indirect effect on the financial statements. The Yellow Book, at Paragraph 7.17, states that the auditor "should extend the AICPA's requirements pertaining to the auditors' responsibilities for laws and regulations to also apply to consideration of compliance with provisions of contracts or grant agreements."

The HUD audit guide extends this concept and requires the auditor to opine on whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements applicable to its major HUD programs. The Uniform Guidance also extends the concept, requiring the auditor to determine whether the auditee has complied with laws, regulations, and the provisions of contracts or grant agreements that may have a direct and material effect on each major program. Accordingly, when developing the audit plan, the auditor assesses not only the risk that noncompliance may cause the financial statements to contain a material misstatement, but also the risk that noncompliance may have occurred. The auditor also considers risk factors related to (a) the risk of noncompliance with those laws, regulations, contracts, and grant agreements, and (b) the related control activities designed to prevent or to detect such noncompliance. The auditor also specifically assesses both the risk of material misstatement of the financial statements and the risk of material noncompliance with a major HUD program's compliance requirements occurring due to fraud. The auditor should consider that assessment when designing the audit procedures to be performed.

In a HUD audit engagement, auditors should obtain a level of knowledge of the entity that will enable them to understand the events, transactions, and practices that, in their judgment, may have a significant effect on the financial statements and on each major HUD program. These matters are discussed in Lesson 2.

Assessing Risk of Material Noncompliance—Financial Statement Audit. In assessing the risk that noncompliance might cause the financial statements to be materially misstated, the auditor should assess the risk that noncompliance might cause a material misstatement of the financial statements and design the audit to provide reasonable assurance of detecting such noncompliance. The GAS/SA Audit Guide, Paragraph 3.47, states that the auditor should obtain an understanding of relevant provisions of laws, regulations, contracts, and grant agreements and how the entity is complying with them. In addition, the auditor should perform procedures for the purpose of identifying instances of noncompliance with provisions of laws, regulations, contracts, and grant agreements that may have a material effect on the financial statements. Paragraph 3.47 identifies the following procedures that are among those the auditor might perform to assess management's identification of compliance requirements and obtain an understanding of their possible financial statement effects:

- Consider information about compliance requirements obtained in prior audits.
- Discuss the compliance requirements with the entity's chief financial officer, legal counsel, or grant administrators.
- Review directly related agreements, such as grant and debt agreements.

- Obtain an understanding from management about the sources of revenue, review related agreements, and inquire about overall regulations on accounting for the revenue.
- Obtain copies of federal and state laws and regulations affecting the entity and review relevant sections, such as those which address financial reporting, budget, and procurement matters.
- Review minutes of governing body meetings for information about contracts and grant agreements that have a material effect on the financial statements.
- Inquire of oversight organizations about applicable compliance requirements, including statutes and uniform reporting requirements.
- Review information about applicable compliance requirements, such as information in the HUD audit guide, the OMB Compliance Supplement, the Assistance Listing, and state and local policies and procedures.
- Review guidance in applicable AICPA Audit and Accounting Guides and in content available from other professional organizations, such as state CPA societies or industry associations.
- Inquire of grantor, finance personnel, or program administrators about program and grant restrictions, limitations, terms, and conditions.

The GAS/SA Audit Guide cautions auditors that other audit procedures they perform may bring instances of noncompliance to their attention.

To understand the possible financial statement effects of compliance requirements, the authors believe it might help to consider:

- The likelihood of noncompliance occurring.
- Whether the financial statement effect is quantitatively or qualitatively material.
- The level of personnel involved in the compliance-assurance process.
- Whether there is an opportunity for noncompliance to be concealed.

Assessing Risk of Material Noncompliance—Compliance Audit. As part of assessing the risks of material noncompliance in a HUD audit, the auditor should assess both the risk that noncompliance may cause the financial statements to contain a material misstatement and the risk that noncompliance may have a material effect on each major HUD-assisted program. Paragraph 6.40 of the GAS/SA Audit Guide states the auditor should:

- Identify risks and related controls when obtaining an understanding of the entity and its environment.
- Relate the identified risks to what can go wrong at the relevant compliance requirement level.
- Consider whether the likelihood and magnitude of the risks could result in noncompliance with requirements that have a direct and material effect on major HUD programs.

AU-C 935.15–.16 requires the auditor to perform risk assessment procedures for the compliance audit, which should include the following:

- Inquiring of management about whether reports or other written communications from previous audits, attestation engagements, and internal or external monitoring have findings and recommendations that directly relate to the objectives of the compliance audit.
- Obtaining an understanding of management's response (e.g., corrective actions) to findings and recommendations that could have a material effect on compliance.
- Using the information obtained about the findings and recommendations to assess risk and determine the nature, timing, and extent of compliance audit procedures, including procedures to test corrective actions.

AU-C 935.17 states that, for each applicable compliance requirement, the auditor should assess the risks of material noncompliance, whether due to error or fraud, and consider whether any risks might affect multiple compliance requirements (that is, whether the risks are pervasive). For example, there might be a pervasive risk of noncompliance if the HUD-assisted entity has financial difficulties that present an increased risk of noncompliance with reserve for replacements requirements, or if the entity has poor record-keeping to document tenant eligibility for government programs. The auditor should develop an overall response to any pervasive risks of material noncompliance that are identified. (Lesson 2 provides a list of factors to consider when assessing the risks of material noncompliance in a compliance audit.)

Assessing Risks of Material Noncompliance Due to Fraud. The auditor should specifically assess fraud risk throughout the audit. In the context of the compliance portion of the HUD audit, *fraud risk* is the risk of material noncompliance with a HUD program's compliance requirements occurring due to fraud. It relates to fraudulent acts that may result in noncompliance with a HUD program's compliance requirements or in the misappropriation of federal funds.

Types of Risk Assessment Procedures. AU-C 300 and 315A specifically identify the following audit procedures and related activities as necessary risk assessment and other planning procedures:

a. Preliminary engagement activities, including establishing an understanding with the client.

b. Inquiries of management, internal audit (if applicable) and others within the entity and those charged with governance.

c. Analytical procedures.

d. Observation and inspection. [Examples of such procedures include visits to the entity's premises and tracing transactions through the information system (that is, walkthroughs).]

e. Discussion among the engagement team.

All of the risk assessment procedures are performed when obtaining an understanding of the entity and its environment. However, each of those procedures need not be performed for every component of the understanding outlined in Lesson 2. Nevertheless, the standards are explicit in indicating that inquiry alone is not sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control. The discussion among the engagement team about the susceptibility of the entity's financial statements (including the individual statements and disclosures) to material misstatement is required by AU-C 315A.11, and AU-C 240.15 expands on the discussion as it relates to brainstorming about susceptibility to material misstatement due to fraud.

As listed above, AU-C 935.15–.16 establishes specific risk assessment procedures that should be performed in an audit of compliance.

Nature, Timing, and Extent—General Considerations. The nature, timing, and extent of some risk assessment procedures may be relatively consistent across audit engagements, but some procedures will need tailoring in response to the information gathered. For example, in all audits the auditor will make inquiries of management about the rise of fraud, accounting policies and other aspects of the financial reporting process. However, determining others within the entity to whom similar questions may be directed will depend on the circumstances and the specific information gathered about the entity. Thus, performing risk assessment procedures often can begin without extended consideration of their nature, timing, and extent, but other aspects of the risk assessment procedures can only be determined after some information is gathered about the entity and its environment.

Gathering Information Needed to Identify Fraud Risks. In connection with obtaining an understanding of the HUD project and the HUD-assisted multifamily housing industry, auditors may become aware of information that is relevant to identifying fraud risks. AU-C 240.17–.24 explains that auditors should perform the following procedures to obtain information that is used to identify fraud risks:

- Inquire of management, others in the entity, and those charged with governance about the risks of fraud and how they are addressed.

- Consider the results of analytical procedures.
- Consider the existence of fraud risk factors.
- Consider certain other information, such as identified inherent risks and information resulting from the discussion among engagement team members, client acceptance and continuance procedures, and reviews of interim financial statements and other reports.

Fraud considerations are discussed in Lesson 2.

Using the Results of Risk Assessment Procedures Performed in Prior Periods. Because professional standards require the performance of risk assessment procedures to obtain an understanding of the entity and provide a basis for the assessment of risks, can the auditor use information gathered from procedures performed in a prior period and limit the extent of current year procedures? Similarly, can information obtained from the auditor's previous experience with the client be used in identifying risks of material misstatement? The answer is a qualified "yes" to both questions.

The process of understanding the entity's operations and the HUD-assisted multifamily housing industry is continual. For a new engagement, a basic level of knowledge is needed to begin preliminary planning. However, a significant amount of knowledge is gained during the audit. The auditor's previous experience with the entity contributes to the understanding of the entity and its environment. For example, in previous audits the auditor may have learned whether:

- The entity maintains current accounting policies and procedures manuals.
- Reports required by HUD, state or other federal agencies are submitted on a timely basis.
- Internal control weaknesses or compliance findings are resolved on a timely basis.
- The entity maintains its day-to-day accounting records on a cash basis and converts the financial statements to a GAAP basis only at year end. (If an entity does not follow GAAP during the year and attempts to record material correcting entries at year end, there may be an increased risk that the financial statements will be materially misstated.)

Audit procedures performed in previous audits ordinarily provide useful audit evidence about the following:

- The entity's organizational structure, federal award programs, controls, and operations.
- Past misstatements and noncompliance and whether they were corrected on a timely basis.

Information about past misstatements and noncompliance assists the auditor in assessing risks in the current audit. Before using information obtained in prior periods, however, AU-C 315A.10 requires auditors to ascertain whether changes have occurred since the last audit that may be relevant in the current audit. The auditor is interested in identifying changes in personnel, procedures, processes, contracts, products and services; contingencies; facilities and the nature of the business; ownership, management, and financial condition; conditions and events or operating results that are relevant to the going concern assumption; loan covenant compliance and litigation status; control environment or activities; fraud risks; management attitude toward, or pressures on, the auditors; scope of the engagement; and any other internal or external conditions that might be of audit significance. These changes may change the client's business risk or the auditor's assessment of risks of material misstatement and noncompliance. Therefore, the auditor performs risk assessment procedures in the current audit to determine whether changes have occurred that impact the relevance of information gathered in previous audits. For example, auditors might perform inquiries of key client personnel, supplemented by observation and inspection (for example, review of interim financial reports and walkthroughs) to determine what changes have occurred.

Paragraph 3.132 of the AICPA Audit Guide *Assessing and Responding to Audit Risk in a Financial Statement Audit* (AICPA Risk Assessment Audit Guide) specifically notes that the nature, timing, and extent of procedures performed to update the understanding of the client obtained in prior periods may depend on matters such as—

- Significance of the changes to the entity or its environment that have occurred since the prior period.
- Relative significance of the risks of material misstatement that may be affected by changes to the entity or its environment.
- Reliability of evidence available to support conclusions about any changes (or lack of changes)from the prior period.

Although the auditor's procedures always include inquiries, observation, and inspection, the authors believe the extent of risk assessment procedures will often be considerably less in continuing audit engagements than in initial engagements, consisting primarily of sufficient procedures to identify and evaluate changes. The extent of current period risk assessment procedures may need to be increased, however, in response to the following:

- The information relates directly to a past misstatement/noncompliance or risk of material misstatement/ noncompliance identified in the prior year.
- Other information obtained through risk assessment procedures indicates a possible significant change in the current year.
- There is a greater likelihood that significant changes will occur given the nature of the information.

The following paragraphs address risk assessment procedures and their role in identifying and assessing risk.

Inquiries of Management and Others

Inquiry of management and others is used extensively throughout the audit planning process. AU-C 315A.06 specifically requires the auditor to make inquiries of management, internal audit (if such a function exists), and others within the entity who may have information that is likely to help in the identification of risks of material misstatement whether due to error or fraud. In many cases, inquiry serves as a foundation for the performance of other risk assessment procedures in that the responses obtained drive the need for additional or corroborating procedures. Inquiry consists of several elements—posing a question or requesting information on a matter, evaluating the response, and following up to obtain additional information as needed. As such, inquiry can be an extremely effective procedure in identifying risks. The auditor evaluates the response obtained and determines if a potential risk exists. If the auditor deems that there is an indication of risk, additional inquiries might be posed to further identify the risk and determine whether other risk assessment procedures are necessary.

Although inquiry is a critical risk assessment procedure, inquiry cannot be used alone when identifying and assessing risks. Auditors use a combination of inquiry, analytical procedures, and observation and inspection during the risk assessment process. Furthermore, auditors are prohibited from only using inquiry when evaluating the design and implementation of internal control.

Matters and Parties of Inquiry. Auditing standards require the auditor to inquire of management and others in the entity about the following matters relevant to audit planning:

a. The entity and its environment as enumerated in AU-C 315A.
b. Fraud-related matters as enumerated in AU-C 240.
c. Related parties and related party transactions as enumerated in AU-C 550.
d. Accounting estimates as enumerated in AU-C 540A.
e. Compliance with laws and regulations as enumerated in AU-C 250.

f. Communications from service organizations about fraud, noncompliance with laws or regulations, or uncorrected misstatements at the service organization that affect the entity's financial statements, as enumerated in AU-C 402.19.

g. Management's preliminary evaluation of whether conditions or events exist that raise substantial doubt about the entity's ability to continue as a going concern for a reasonable period of time, as enumerated in AU-C 570, *The Auditor's Consideration of an Entity's Ability to Continue as a Going Concern*.

h. Whether reports or other written communications from previous audits, attestation engagements, and internal or external monitoring have findings and recommendations that directly relate to the objectives of the compliance audit as required by AU-C 935.

In addition to inquiries of management, inquiries of others within and outside the entity are either required or can provide useful information. Examples of inquiries of others include the following:

a. *Those Charged with Governance.* Their involvement in the financial reporting process and how the financial statements are used. [AU-C 240.21 requires the auditor to inquire directly of those charged with governance (or the audit committee, or at least its chair) about the risks of actual, suspected, or alleged fraud; their knowledge of actual, suspected, or alleged fraud; and whether the entity entered into significant unusual transactions.]

b. *Internal Audit.* Activities concerning the design and effectiveness of internal control and management's responses to any findings by the internal audit function, if the entity has an internal audit function. (AU-C 315A.06 requires inquiries of appropriate internal audit personnel who may have information on risks of material misstatement due to fraud or error, or who can assist in identifying such risks. AU-C 240.19 requires inquiry of internal audit personnel about risks of fraud, knowledge of actual, suspected, or alleged fraud, activities concerning fraud detection, whether management satisfactorily responded to any findings, and whether the entity entered into significant unusual transactions.)

c. *Other Employees.* Their role in the financial reporting process and additional or corroborating information to support management's responses. (AU-C 240.A18–.A19 and AU-C 315A.A7 include discussions of the benefits of inquiry and provides examples of others within the entity to whom the auditor may direct inquiries about the existence or suspicion of fraud.) Auditors may consider obtaining the perspective of employees from different functional areas and at varying levels of authority. Examples of inquiries that might be made of others include the following:

   (1) *Financial Reporting Personnel.* Appropriateness of the selection and application of accounting policies, including the initiation, authorization, processing, or recording of complex or unusual transactions. (AU-C 240.32 explicitly requires inquiries about knowledge of inappropriate or unusual activity relating to the processing of journal entries and other adjustments.)

   (2) *Compliance Officers, or Grant or Contract Administrators.* Their understanding of the applicable compliance requirements and the entity's compliance with the requirements.

   (3) *IT Systems Personnel or Users.* Their role in identifying changes to IT systems, how frequently changes occur, effectiveness of application and access controls, and excessive system downtime and other functional issues.

   (4) *Risk Management Personnel.* Information about operating, regulatory, and other risks that may affect financial reporting.

d. *Parties outside the Entity.* Inquiries of parties outside the entity are not required but are procedures that might be helpful. For example, the auditor might find it useful to make inquiries of the office of the federal or regional HUD program official or auditor, other appropriate audit oversight organizations or regulators, external legal counsel, or of valuation experts that management has engaged. The auditor might also find it useful to make inquiries of customers, suppliers, or regulators to better understand the nature of the entity and its operations.

e. *Management Agent.* The management agent can provide valuable information to auditors about vacancy rates, compliance with HUD requirements, and the HUD-assisted project's overall operations.

During the process of identifying risks unique to HUD entities that could affect the financial statements and HUD program compliance, the auditor should consider questions such as the following:

- Does the owner have an unfavorable or declining relationship with HUD or other agencies?
- What were the results of previous financial or OIG audits or REAC reviews?
- Does the entity have an inactive managing partner?
- What is the general condition of the project?
- What are the conditions of the local housing market?
- Is the management company or another vendor a related party?

Fraud-related Inquiries. The consideration of fraud in a financial statement audit is an integral part of obtaining an understanding of the entity and its environment and assessing the risks of material misstatement. AU-C 315A.09 explains that during planning the auditor should consider the results of the fraud risk assessment along with the other information obtained as part of identifying the risks of material misstatements. AU-C 240.15 notes that the discussion among the engagement team required by AU-C 315A should include fraud brainstorming, and AU-C 315A.29 also notes that the auditor should consider fraud risks in identifying significant risks. The inquiries of management made in audit planning, according to AU-C 240.17–.18, should include the following specific areas of inquiry:

- Whether they have knowledge of any actual, suspected, or alleged fraud.
- Management's process for identifying, responding to, and monitoring the risks of fraud in the entity.
- The nature, extent, and frequency of management's assessment of fraud risk and the results of those assessments.
- Any specific risks of fraud that management has identified or that have been brought to its attention.
- The classes of transactions (or HUD programs), account balances, or disclosures for which a fraud risk is likely to exist. (The GAS/SA Audit Guide, Paragraph 6.43, explains that the auditor also inquires about any knowledge of possible or actual noncompliance or abuses of programs and controls that occurred during the period under audit or subsequent to that date.)
- Management's communications, if any, to:
  - Those charged with governance on its process for identifying and responding to fraud risks.
  - Employees on its views on appropriate business practices and ethical behavior.
- Whether any significant unusual transactions have been entered into; if so, the nature, terms, and business purpose (or lack thereof); and whether such transactions involved related parties.

The areas of inquiry required by AU-C 240 include management's processes and assessment methods, as well as knowledge of identified risks or actual, suspected, or alleged fraud. Naturally, auditors give more weight to information about risks and knowledge of fraud if management has effective processes and assessment methods. However, because management may be in the best position to commit fraud, the responses of members of senior management concerning the likelihood of them committing fraud are far less meaningful than their responses with respect to fraud being committed by lower level personnel.

Additional *Government Auditing Standards* Requirements. *Government Auditing Standards* indicates that auditors should make inquiries about findings and recommendations from previous engagements and evaluate whether appropriate corrective actions have been taken to address findings that could have a material effect on the financial statements. The Yellow Book, at Paragraph 6.11, states that auditors should ask management "to identify previous audits, attestation engagements, and other studies that directly relate to the objectives of the audit, including whether related recommendations have been implemented." Auditors should use this information when assessing risk and determining the nature, timing, and extent of audit work, including the testing of implementation of corrective actions. (As discussed in Lesson 2, AU-C 935 has similar requirements for findings that could have a material effect on compliance.)

Exhibit 1-2 presents a list of questions about fraud the auditor might consider asking management or the project owner of a HUD project. Exhibit 1-3 provides illustrative inquiries that might be appropriate for employees of different levels and departments.

Exhibit 1-2

Inquiries about Fraud Risks for Management, the Project Owner, and/or Management Agent

Recommended Areas of Inquiry	Possible Questions
Knowledge of any actual fraud or suspicions of fraud affecting the entity.	• Are you aware of any actual instances of fraud within the entity? • Do you have any suspicions that fraud may be occurring within the entity? If so, where and how? • Have you seen any changes in employee behavior?
Awareness of any allegations of fraud or suspected fraud affecting the entity.	• Have you received any communications from employees, former employees, regulators, or others alleging fraud?

Recommended Areas of Inquiry	Possible Questions
Frequency and ways they assess the risk that the entity's financial statements might be materially misstated due to fraud and the controls in place to prevent and detect it.	• What is your process (how, to what extent, and how often) for assessing the risk that the entity's financial statements might be materially misstated due to fraud? • What is your process (how, to what extent, and how often) for assessing the controls in place to prevent and detect fraud? • What incentives or pressures exist to commit fraud? • What opportunities are available for fraud to be carried out? • Are you aware of any attitudes (or potential rationalizations) on the part of employees that might enable them to justify fraud? • What would be the easiest way for someone to misstate the financial statements or misappropriate assets without getting caught? • If someone were going to overstate or understate operating income, how would they do it? • If someone were going to steal and cover it up, how would they do it? • Does the entity use source documents that could be easily accessed and forged? • How could a false entry be made to the accounting system? • What departures from GAAP are most common in your industry? What departures from GAAP are most likely at your entity? • What types of noncompliance with HUD program regulations are common for multifamily projects? • Where are the weaknesses in the entity's internal controls, including compliance controls? • Which controls can be bypassed or overridden? Are there instances where controls have been bypassed or overridden in the past?
How they communicate to employees the importance of ethical behavior and appropriate business practices.	• What instructions do you give to employees about how they are expected to behave when conducting business? • How do you make it clear to employees that fraudulent or unethical behavior will not be tolerated?

Recommended Areas of Inquiry	Possible Questions
Processes (programs and controls) for identifying, responding to, and monitoring fraud risks, including any (1) specific fraud risks they have identified or that have been brought to their attention; or (2) classes of transactions, account balances, disclosures, or HUD program requirements for which a fraud risk is likely to exist.	• What measures have you taken to address specific risks of fraud within the entity? • What controls have been implemented to prevent one person from perpetrating and concealing a fraud when segregation of duties is not possible? • What procedures are in place for initiating, approving, and processing significant unusual transactions? • Are there any other programs and controls in place to help prevent, deter, or detect fraud? • How do you monitor the entity's antifraud programs and controls to make sure they are working as intended? • Which types of transactions, account balances, financial statement classifications, or entity locations are most at risk for intentional misstatement or theft? • Have you identified any specific risks of fraud within the entity?
The nature, terms, and business purpose (or lack thereof) of any significant unusual transactions entered into by the entity; and whether such transactions involved related parties.	• Are you aware of the entity entering any significant unusual transactions, including transactions involving related parties? • If so, what are the nature, terms, and business purpose of the significant unusual transactions?
Nature and extent of monitoring multiple locations and whether any of them have a higher level of fraud risk.	• Do fraud risks exist or are they more likely to exist in particular locations or components? • How do you monitor the entity's operating locations to reduce the likelihood of fraud occurring and going undetected?
Whether they have reported to those charged with governance about the entity's processes for identifying and responding to fraud risks.	• Have you reported to the audit committee (or its equivalent) about how the entity's internal control serves to prevent, deter, and detect material misstatements or noncompliance due to fraud?

AU-C 240.32 requires that the auditor make specific inquiries of individuals involved in the financial reporting process about inappropriate or unusual activity relating to the processing of journal entries and other adjustments. The authors believe that these inquiries might be combined with inquiries such as those in Exhibit 1-3 during audit planning, but that the inquiries need to be followed up later by inquiries that cover the period through the end of the closing process and preparation of financial statements.

Exhibit 1-3

Possible Inquiries about Fraud Risk for Project Employees

Suggested Questions	Direct Inquiries to
• Do you understand what fraud is and can you provide an example or a definition of fraud? • Does management make you aware of the importance of ethical behavior and appropriate business practices? If so, how? • Are you aware of any allegations of fraud or suspected fraud affecting the project? If so, please describe. • Are you aware of any programs in place to help employees learn to identify fraud and report it? If so, please describe the programs and comment on their effectiveness. • Is the project physically secured to prevent fraud or misuse of the project's assets? If not, how do you believe the project is susceptible to fraud or misuse of assets as a result? • Are you aware of any areas where the project or management are not in compliance with laws and regulations? If so, please describe. • Do you know of anyone who is stealing from the project? • Do you suspect that anyone is stealing from the project? • Do you know of anyone who is manipulating the accounts or records? • How could someone steal from the project without getting caught? • If I were to [Indicate potential fraud.], how would I get caught? • How would you describe the project owner's (and/or management company's) values and ethics? • What is it like to work here? How is the overall morale? • Are you upset with the owner and/or management company for any reason? Do you know of anyone who is? • Have you ever been asked to ignore or override a policy or procedure that is part of your job? Who asked you? • Have you ever seen another employee circumventing policies, procedures, or controls? What explanation did they give? • Have you noticed any unusual changes in the behavior or lifestyle of management or any other employees? • Do you know of any employees who are under pressure to make ends meet financially? • How do you think this project owner and/or management company compares with others in terms of the honesty of its employees? • Do you think your co-workers are honest? • Has anyone you work with ever asked you to do anything you thought was illegal or unethical? What would you do if someone asked you? • Have you ever been asked to enter false information in the (accounting/rental/personnel) system or records? • Has anyone you work with ever asked you to withhold information from the auditors or alter documents or records?	All employees selected

Suggested Questions	Direct Inquiries to
• Has the entity communicated how to report suspected fraud? If so, would you feel comfortable in reporting suspected fraud in this manner? Do you believe that reporting suspected fraud would not be held against you by the owner, management or others? • Is there anything else you would like to add, or anyone else we might talk to? • I have one last question. Have you yourself done anything against the project that was illegal or unethical?	
• What factors (such as local competition or changes in available subsidy programs) may threaten the project's ability to stay in business or earn a profit? • How would reporting improved financial results help the project? • What pressure is put on employees to achieve the project's financial goals, and by whom? • Have there been any recent changes in leasing policies or terms offered to tenants? • Were any large or unusual leases or contracts entered into at or near the end of the year? • What types of tenant complaints do you typically receive?	Leasing and marketing
• How is management and/or the board compensated? • Have the owner or management exerted any pressure upon you or others to override, modify, or falsify compensation awards, agreements, or plans without sufficient justification and approval for the situation? • How are financial targets used to determine employees' pay or benefits? For example, do bonuses depend on project net operating income or leasing targets? • Has there been any significant turnover in personnel? In what departments? • Are there any recent or planned layoffs or changes in pay rates or benefit plans that have or could upset the workforce? • Have recent bonuses, raises, and promotions met employee expectations? Is there anything planned in those areas that could cause resentment among employees? • Have employees complained about work conditions, management demands or style, or other matters that could lead to pressures or incentives to commit fraud? • Have employees been punished or terminated for whistle-blowing or otherwise bringing unethical or fraudulent practices to the attention of appropriate internal or external parties?	Human resources

Suggested Questions	Direct Inquiries to
• How active is management in supervising the accounting department? • Does management (including senior finance executives) demonstrate an attitude of "shoot the messenger" when learning of unfavorable financial results or incidents? • What are the weaknesses in the project's internal controls? • Do any of the project's accounting policies seem inappropriate or overly aggressive? • Does management always tend to favor amounts that are on the high (low) side when developing accounting estimates, such as estimated liabilities and valuation accounts? • Does management often use materiality to justify questionable accounting practices? • Does it ever seem like the method of accounting for a transaction is more important than the transaction itself? Can you give me an example? • Does the project owner run personal expenses through the business? • What aspect of the project's performance are the owner and management most concerned about? • Are there any changes in procedures or improvements in controls that could easily be made, but management has chosen not to? • Have there been any unusual changes in the way transactions are processed? • Are there any third parties that have expectations about (or a stake in) the project's performance? What are their needs or expectations? • Have you ever been asked to record any journal entries that seemed unusual or lacked support? • Have you ever been asked to make false entries in the accounting records?	Accounting and finance
• Has the project's relationship with particular suppliers significantly changed (improved or deteriorated) in the past year? • What types of vendor complaints do you typically receive? • Do any vendors have a close or unusual relationship with the owner or management?	Purchasing

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Related Party Inquiries. Although many related party transactions occur in the ordinary course of business, some related party relationships and transactions may give rise to higher risks of material misstatement than transactions with unrelated parties. As a result, AU-C 550.14 requires the auditor to make specific inquiries of management and others regarding related parties. In addition, auditors are required by AU-C 550.15 to inquire of management and others within the entity and perform other risk assessment procedures as needed to understand the controls over related party relationships and transactions.

Going Concern Uncertainty Inquiries. AU-C 570.12 requires that the auditor consider, when performing risk assessment procedures, whether there are aggregate conditions or events that raise doubt about the entity's ability to continue as a going concern for a reasonable period of time. As part of risk assessment procedures, the auditor is required to determine if management has performed a preliminary evaluation of whether such conditions or events have been identified. If so, auditors and management should discuss management's evaluation of conditions or events that raise substantial doubt about the entity's ability to continue as a going concern, as well as plans to address any issues identified. If management has not yet made such an evaluation, the auditor is required to discuss with management the intended use of the going concern basis and inquire as to any existing conditions or events that raise substantial doubt about the entity's ability to continue as a going concern. Auditors would consider management's evaluation in the risk assessment process and remain alert throughout the audit for any evidence indicating conditions or events that raise substantial doubt regarding going concern.

Inquiries about Accounting Estimates. Because of the nature of accounting estimates, there can be a high degree of estimation uncertainty. As a result, AU-C 540A.08 indicates that, when obtaining an understanding of how management identifies transactions, events, and conditions requiring accounting estimates, the auditor should make inquiries of management about whether any changes in circumstances have occurred that may give rise to new accounting estimates or the need to revise existing estimates.

Inquiries about Compliance with Laws and Regulations. AU-C 250.14 requires the auditor to inquire of management and those charged with governance about whether the entity is in compliance with laws and regulations that may have a material indirect effect on the financial statements and to inspect relevant correspondence with licensing and regulatory authorities. The focus of the auditor's inquiries is on laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements. However, compliance with those laws and regulations may be fundamental to the operating aspects of the entity, fundamental to an entity's ability to continue as a going concern, or necessary for the entity to avoid material penalties. Examples include compliance with an entity's operating license and with laws or regulations related to occupational safety and health, etc. The auditor may also inquire about the entity's policies and procedures regarding compliance with laws and regulations (including the prevention of noncompliance); the policies or procedures adopted for identifying, evaluating, and accounting for litigation claims; and the use of directives and periodic representations obtained from management at appropriate levels of authority concerning compliance with laws and regulations.

Inquiries Related to Service Organizations. AU-C 402.19 requires the auditor to inquire of management about whether a service organization has reported to them, or whether they are otherwise aware of, any fraud, noncompliance with laws and regulations, or uncorrected misstatements at the service organization that affect the financial statements of the user entity. The auditor should evaluate how such matters, if any, affect the nature, timing, and extent of further audit procedures. If the auditor needs additional information to perform this evaluation, it may be necessary to ask the user entity to contact the service organization to obtain the necessary information.

Documentation. AU-C 935 requires documentation of risk assessment procedures. AU-C 935.40 states that the auditor's documentation should include the risk assessment procedures performed, including those related to obtaining an understanding of internal control over compliance. There are no specific documentation requirements for inquiries made as risk assessment procedures, but AU-C 230 provides pertinent guidance. AU-C 230.09 states that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the items or matters tested. AU-C 230.A14 suggests that, for a procedure involving inquiries of entity personnel, the auditor records the inquiries made, the dates of inquiries, and the names and job designations of the personnel. The authors recommend documenting such matters when performing risk assessment inquiry procedures.

Analytical Procedures

AU-C 315A.06 specifies that risk assessment procedures should include analytical procedures, and AU-C 315A.A14 notes that analytical procedures performed as risk assessment procedures may encompass both financial and nonfinancial information. AU-C 315A.A15–.A16 explains that unusual or unexpected relationships identified may assist the auditor in identifying risks of material misstatement, especially risks of material misstatement due to fraud, but when analytical procedures use data aggregated at a high level, the results provide only a broad initial indication about whether a material misstatement may exist.

Knowledge of the client and the multifamily real estate industry is interrelated with the use of analytical procedures in audit planning. Performing effective preliminary analytical procedures requires the auditor to understand the HUD project and the multifamily real estate industry to know what relationships would be expected to exist, what relationships would be considered unusual or unlikely, and what plausible explanations might exist for observed relationships. That knowledge is also important in assessing the significance of differences from expected relationships. The auditor's knowledge and understanding of the entity can also be improved by applying preliminary analytical procedures in audit planning. The use of particular analytical procedures is not required. The sophistication, extent, and timing of analytical procedures may vary widely, depending on the size and complexity of the client. Analytical procedures might include reviewing changes in account balances from the prior to the current year using the general ledger or the auditor's preliminary or unadjusted working trial balance or analysis of ratios or trends related to profitability, liquidity, solvency, and activity combined with inquiries of financial and operating management.

In the audit of a HUD-assisted project, simple comparisons and ratios are ordinarily effective, and the auditor normally need not make use of complex mathematical or statistical models. A comparison of significant account balances with prior period amounts can improve the auditor's understanding of the entity and its operations. Are there significant fluctuations in rental revenues and receivables? Do changes in operating expense make sense in relation to revenues? Other analytical procedures may consist primarily of analysis of ratios or trends related to profitability, liquidity, solvency, and activity combined with inquiries of the project's management.

AU-C 935 Guidance on Analytical Procedures. AU-C 935.A23 explains that using analytical procedures to gather substantive evidence is generally less effective in a compliance audit than it is in a financial statement audit. However, substantive analytical procedures may contribute some evidence when performed in addition to tests of transactions and other auditing procedures necessary to provide the auditor with sufficient appropriate audit evidence. AU-C 935.19 states that risk assessment procedures, tests of controls, and analytical procedures alone are not sufficient to address a risk of material noncompliance. The auditor should also design and perform further audit procedures, including tests of details (which may include tests of transactions) to obtain sufficient appropriate audit evidence about the entity's compliance with each of the applicable compliance requirements in response to the assessed risks of material noncompliance.

Examples of analytical procedures that fit the specialized circumstances of a HUD client and its operations are presented below. For example, some HUD entities may be motivated to overstate net income to meet certain funding requirements. However, comparisons of actual cash flow with recorded accrued amounts and comparisons of the total recorded amount with the portion that is dependent on a subjective estimate are generally useful.

In addition to the requirement in AU-C 315A to perform analytical procedures as part of risk assessment procedures, AU-C 240.22 requires that, to the extent they are not already included, analytical procedures should include procedures related to revenue. Auditors perform preliminary analytical procedures related to revenue to identify unusual or unexpected relationships that may indicate fraudulent financial reporting. Ordinarily, comparison of current and prior-period account balances for revenue accounts are not sufficient to achieve that objective, and other types of analytical procedures are used. Other analytical procedures that may be useful in identifying unusual or unexpected relationships related to revenue include the following:

- *Analysis of Relationships between Financial and Nonfinancial Amounts.* When comparing financial and nonfinancial amounts, it may be most effective to use a base that (a) would be expected to have a reasonable relationship to revenue, and (b) could not easily be manipulated by management or the project owner. For example, auditors may compare HAP reports to recorded rental revenue.

- *Trend Analysis.* Auditors may analyze trends in the components of revenue or transaction types. It may be helpful to look at several trends or relationships to identify inconsistencies or unusual patterns. For example, the auditor might consider whether the rent rolls indicate unusual patterns that could be indicative of misstatements.

- *Ratio Analysis.* Ratio analysis is the analysis of relationships between financial statement items by computing the ratio of one financial statement item to another. The ratio may be compared to the same ratio for a prior period (or several prior periods) to identify unusual or significant variations. In a HUD engagement, certain ratios may be used to improve the auditors' understanding of the client. The debt to equity ratio provides information on the entity's capital structure. Other common ratios are tenant rental assistance as a percentage of total rents, total cost of debt as a percentage of total tenant rents, the allowance for uncollectible accounts as a percentage of tenant rent receivables, and bad debt expense as a percentage of tenant rent receivables. Ratios that use information that management generally is unable to manipulate, such as cash flows, may be most effective in revealing indications of fraudulent financial reporting.

- *Budgetary Comparison.* Comparison of actual amounts with budgets may also indicate unusual variations. For example, revenue might significantly exceed budget because of improper revenue recognition.

Imaginative use of analytical procedures can be useful in refining the risk assessment for detecting the misstatement. If the auditor focuses on trends that are difficult or impossible to manipulate by the perpetrator, analytical procedures will generally be more effective. Volume data trends should follow reported amounts. For example, in HUD entities, the auditor could compare the following:

- For commercial tenants, the current year rental income per square foot.
- Actual rental income per unit with established rates.
- The number of employees and payroll costs.

However, when auditing a HUD entity, the auditor may find that the accounting for some revenue transactions is relatively complex. For example, in Section 236 projects, the owner calculates two rent payments for each tenant—one based on a mortgage that carries a market interest rate (referred to as the *market rent*) and another based on a 1% mortgage (referred to as the *basic rent*). Each tenant is required to pay the higher of the basic rent or 30% of the tenant's adjusted gross income.

Financial statement accounts are often linked in an operating cycle that should result in plausible, persistent relationships. The account relationships in HUD entities are no different. For example, if rental revenues are increasing, but the operating expenses per unit are decreasing, the auditor should question why and regard management's response skeptically. Unusual trends in rental revenue compared to operating expenses might indicate that either revenue is overstated, expenses are understated, or the project is not being operated in accordance with HUD requirements. As another example, management may explain that management agent fees are down. The auditor should not accept the explanation at face value. The auditor could review management expenses and the contract with the management agent and determine that expenses were properly recorded and classified. The auditor should evaluate explanations in light of the knowledge and understanding obtained from applying other audit procedures.

When the results of preliminary analytical procedures indicate the existence of unusual or unexpected relationships, the auditor should consider those results in identifying risks of material misstatement of the financial statements. Analytical procedures should be updated in the final review stage of the audit.

Documentation. Documentation of preliminary analytical procedures can be limited, but it needs to be sufficient to provide support for the auditor's risk assessment. The results of the preliminary analytical review ordinarily are documented using a narrative memorandum, comparative carryforward schedule, or other form of workpaper. Documentation may also include the effect on the audit plan or indicate that the results have been considered when identifying fraud risks.

Audit Data Analytics. During the planning of the audit, the auditor may consider using automated tools and techniques, such as audit data analytics (ADAs). AU-C 500.A4 defines *data analytics* as, "the analysis of patterns, identification of anomalies, or extraction of other useful information in data underlying or related to the subject matter of an audit through analysis, modeling, or visualization." Modern technology has advanced, and continues to advance, at an exponential rate, while traditional audit procedures and processes remain virtually unchanged. This creates an opportunity to advance the profession and take advantage of the possibilities these technologies can provide. Before SAS No. 142, *Audit Evidence* (codified at AU-C 500), became effective for audits of financial statements for periods ending on or after December 15, 2022, GAAS did not reference use of data analytics or similar automated tools and techniques, such as artificial intelligence, machine learning, remote observation tools, or robotic process automation. AU-C 500 makes clear that audit procedures performed on information to be used as audit evidence may be performed manually or using such automated tools and techniques.

The AICPA has issued *Guide to Audit Data Analytics (ADA Guide)*, which provides an introduction and overview of data analytic techniques that can be used by financial statement auditors. The *ADA Guide* provides guidance on the use of data analytic techniques in the performance of risk assessment procedures, substantive analytic procedures, and tests of details, along with relevant examples. The *ADA Guide* can be purchased at **www.aicpa.org/cpe-learning**.

Observation and Inspection

According to AU-C 315A.06, risk assessment procedures should include observation and inspection. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the entity and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks. For example, to gain an understanding of the entity's financing arrangements and underlying covenants, the auditor might decide to review the entity's loan agreements and other related documents. That procedure, coupled with a review of the entity's financial statements, might be the key procedure that helps the auditor identify risks related to potential noncompliance with loan covenants.

The auditor should consider facts gained during project site visits and when reviewing HUD physical inspection reports.

More frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of management and others. For example, when evaluating the design and implementation of the entity's system of internal control, members of management might tell the auditor that they communicate the importance of ethical values to employees through a written code of conduct and by example. The auditor might wish to corroborate this response by examining the written code. In addition, the auditor may determine that a risk exists based on observation of management's current and past interactions with employees that contradict the behavior standards in the written code.

When corroborating the client's explanation of differences, the following example illustrates obtaining explanations from accounting personnel in a HUD entity and following-up with operating personnel. For example, the auditor noted that the entity had incurred management agent fees for the project that were not in the current year budget. The entity's accounting personnel explain that during the current year the entity decided to hire a management agent; thus the increase in the fees over the prior year and the variation for the budget. The auditor might investigate the explanation by inspecting the contract with the management agent and vouching the billings from the management agent.

In corroborating explanations of differences, the auditor should consider the results of other audit procedures and the enhanced understanding of the client obtained during the audit. This information might be sufficient and no additional evidence may be considered necessary. Continuing the example in the previous paragraph, the new management agent might be discussed in the board members' or partners' minutes.

Determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. The authors believe that observation and inspection procedures are ordinarily effective in the following situations when obtaining an understanding of the entity:

- To understand the design of controls related to the audit.
- To verify that controls have been implemented, for example, as part of a walkthrough.
- When responses to inquiries indicate a potential risk for a significant account.
- When responses to inquiries are inconclusive, conflicting, or prove to be incorrect.
- In combination with inquiry to fully understand a matter.
- When necessary information can only or best be obtained through observation or inspection.
- When the evidence gathered through observation and inspection can also be used for a substantive procedure.
- In recurring engagements, to determine whether changes have occurred that affect the continued relevance of the information gathered in a prior period.

Documentation. As noted earlier, AU-C 230.09 requires that in documenting the nature, timing, and extent of audit procedures, the auditor should record the identifying characteristics of the specific items or matters tested. AU-C 230.A14 provides examples of how this might be accomplished. Based on that guidance, the authors recommend documenting the following:

- For an inspection of documents, identify the item inspected, for example, by indicating the title and date of the report or the document name and number. (To facilitate inquiring about or requesting copies of the report or document at a later time, the authors recommend referring to the report or document by the same name that the client uses to refer to it.)

- For an observation procedure, document the process or subject matter observed, individuals involved and their titles, and where and when the observation was carried out.

Discussion among the Engagement Team

AU-C 315A.11 requires the key members of the audit team (including the engagement partner) to discuss the susceptibility of the entity's financial statements to material misstatements and the application of GAAP to the entity's facts and circumstances. AU-C 240.15 requires an open exchange of ideas, or "brainstorming" among audit team members about how and where they believe the entity's financial statements, including disclosures, might be susceptible to material misstatement due to fraud, how management could perpetrate and conceal fraudulent financial reporting, and how assets of the entity could be misappropriated. These discussions can be held concurrently, that is, one meeting can cover the susceptibility of the financial statements to material misstatements from both error and fraud. However, it is important that the auditor consider the susceptibility to fraud as a distinct part of this combined discussion to avoid the potential dilution of this critical consideration.

AU-C 935 requires auditors to use professional judgment to adapt and apply GAAS to a compliance audit. Thus, in a HUD audit, the focus of the audit team discussion would be on the individual members gaining a better understanding of the potential for material misstatements and noncompliance resulting from error or fraud in the specific areas assigned to them, and understanding how the results of audit procedures they perform affect other aspects of the audit. In this discussion, the partner and more experienced members of the audit team can share their insights based on their cumulative knowledge of the entity, its industry, and the environment (including its HUD programs). It is not always necessary or practical for the engagement team discussion to include all members in a single discussion, and not all members need to be informed of all decisions made. AU-C 315A.11 states that the engagement partner and key engagement members should take part in the team discussion. In addition, the engagement partner should determine what matters are to be communicated to team members who are not involved in the team discussion.

Matters to Be Discussed. The engagement team discussion is aimed at the susceptibility to material misstatement (including the application of GAAP) or noncompliance; that is, the areas of vulnerability. The discussion is one of the sources of information used to assess the risks of material misstatement. Thus, the discussion ought to open the minds of members of the audit team to potential material misstatements from error and, particularly, from fraud. Any high risk areas that have already been identified, however, also need to be communicated to the team members. The following matters are specifically required to be discussed during the engagement team discussion:

- The susceptibility of the entity's financial statements, including disclosures, to material misstatement.

- The application of GAAP to the entity's facts and circumstances in light of its accounting policies.

- The susceptibility of the financial statements to material misstatement due to fraud or error that could result from the entity's related party relationships and transactions.

- The susceptibility of the entity's major programs to material noncompliance with compliance requirements.

- Fraud-related matters.

- The need to exercise professional skepticism throughout the engagement, to be alert for information or other conditions that indicate that a material misstatement due to fraud or error may have occurred, and to be rigorous in following up on such indications.

In addition, focusing on the areas of vulnerability, the engagement team discussion might include the following topics:

a. Critical issues and areas of significant audit risk.

b. Unusual accounting practices used by the entity.

c. Implementation of new accounting standards.

d. Changes in the entity's environment, financial condition, or activities that may result in significant new or revised accounting or disclosures.

e. Important control systems.

f. Significant IT applications and how the use of IT may affect the audit.

g. Areas susceptible to cyber attacks or intrusion that may affect the audit.

h. Materiality levels and how materiality will be used to determine the extent of testing.

i. How to introduce an element of unpredictability into the nature, timing, and extent of audit procedures.

j. Whether management may attempt to present disclosures in a way that obscures a proper understanding of the matters discussed, such as by the use of unclear or ambiguous language.

Examples of other factors that affect the likelihood of material misstatements or noncompliance that the engagement team might discuss include the following:

- Past experience with the client (including areas with audit difficulty, amounts or disclosures for which it was difficult to obtain sufficient appropriate evidence, and misstatements or noncompliance identified).
- Organizational changes (for example, changes in personnel or accounting systems, or changes in the property manager).
- The nature and complexity of transactions and/or disclosures (including those involving significant judgment from management on how much information to include in disclosures).
- Known accounting and auditing issues.
- The complexity of the applicable compliance requirements.
- The susceptibility of the applicable compliance requirements to noncompliance.
- The length of time the entity has been subject to the applicable compliance requirements.
- The auditor's knowledge about how the entity complied with the applicable compliance requirements in prior years.
- The potential effect on the entity of noncompliance with the applicable compliance requirements.
- The amount of judgment involved in meeting the compliance requirements.
- The effect on the compliance audit of the auditor's assessment of the risks of material misstatement in the financial statement audit.

In addition to discussing important control systems, it may be appropriate to discuss potential risks that may exist due to limitations in the client's personnel and assignment of responsibilities. For some smaller HUD entities, the engagement team might consider issues regarding the background and competence of individuals in key processing, compliance, and financial decision-making roles, especially if concerns had been noted in previous audits.

Related Parties. AU-C 550.13 specifically requires auditors, as part of the engagement team discussion, to consider how related party relationships and transactions could affect the susceptibility of the financial statements to material misstatement. AU-C 550.A7–.A8 indicate that the team discussion might include the following related party matters:

- Nature and extent of the entity's relationships and transactions with related parties.
- Importance of maintaining professional skepticism regarding related parties throughout the audit.
- Circumstances or conditions that may indicate the existence of unidentified related party relationships or transactions.
- Types of records or documents that might indicate the existence of related party relationships or transactions.
- Importance that management and those charged with governance attach to the identification of, accounting for, and disclosure of related party relationships and transactions and the related risk of management override.
- How related parties might be involved in fraud.

The authors recommend that the discussion include reminding the engagement team that if related parties or significant related party transactions are identified by the auditor that were not previously identified and disclosed by management, the engagement team is required by AU-C 550.25 to promptly communicate such information to other team members. Also, AU-C 550.25 requires that the auditor inquire of management as to why applicable controls over related party relationships and transactions failed to identify and disclose such information.

Fraud-related Matters. AU-C 240.15 indicates that the discussion should also include the following fraud-related matters:

- How and where the entity's financial statements (for example, which account balances, transaction classes, or disclosures) might be susceptible to material misstatement due to fraud.
- For areas susceptible to material misstatement due to fraud, the methods management might use to conceal the fraud.
- How the entity's assets could be stolen.
- External and internal factors that might create incentives/pressures, provide opportunities, or enable rationalization of fraud.
- Risk of management override of controls.
- Circumstances that might be indicative of earnings management or manipulation of other financial measures.
- Practices management might use to manage earnings or other financial measures that could lead to fraudulent financial reporting.
- How the auditor might respond to the susceptibility of the financial statements to material misstatement due to fraud.
- Importance of maintaining professional skepticism regarding potential for material misstatement due to fraud.

Effect on Significant Audit Areas. After discussing the risks that could result in a material misstatement of the financial statements or material noncompliance and determining how those risks affect specific audit areas, the authors recommend that the engagement team then discuss each significant audit area. The team ought to focus on the real risks affecting each area and how financial statement misstatements may inter-relate with compliance requirements. For example, for HUD entities, a risk of intentional misstatement may relate to manipulation of amounts to show compliance with regulatory requirements or debt covenants. The team can then discuss the most effective and efficient audit procedures that address those risks. Members of the audit team need to avoid relying on what procedures were performed during the prior year audit when discussing what procedures to perform in the current year. However, after the team has discussed each significant area, the prior year workpapers can be reviewed to make sure there are not any issues that were overlooked. The auditor may consider performing analytical procedures based on reliable revenue data, in addition to supplementing the tests of details in certain circumstances.

Who Attends the Discussion? Key members of the engagement team need to participate in a single discussion, and the engagement partner determines what matters will be communicated to other team members. In addition, it may be appropriate to include specialists, such as IT specialists, assigned to the engagement team. Executive level team members generally are aware of significant accounting and auditing issues that could affect the audit, while staff members or specialists may be more familiar with the client's accounting systems and controls. Both perspectives are important in considering the susceptibility of the financial statements to material misstatements or noncompliance with program requirements due to error or fraud. The authors recommend that all members of the engagement team participate in the discussion.

When Does the Discussion Occur? AU-C 240 and AU-C 315A make it clear that the discussion among the engagement team is expected to occur during the performance of risk assessment procedures as part of audit planning, but the exact timing is not specified. The authors recommend holding the discussion prior to performing the information-gathering procedures discussed in Lesson 2. However, the discussion about the susceptibility of HUD programs to material noncompliance with compliance requirements could be held separately from the general planning meeting for the financial statement audit if the compliance audit of HUD programs is performed at a later date.

Documentation. AU-C 315A.33 requires specific items be documented regarding the discussion among the audit team. AU-C 240 imposes similar documentation requirements related to fraud aspects of the discussion.

In an audit of major HUD programs, the auditor also needs to document the discussion among the engagement team regarding:

- The susceptibility of the major HUD programs to direct and material noncompliance with compliance requirements.
- Significant decisions reached concerning planned responses to compliance requirements.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

9. What is the term for an auditor's operational approach for achieving the objectives of an audit engagement?
   a. Audit plan.
   b. Audit program.
   c. Audit strategy.
   d. Risk assessment.
10. Risk assessment procedures—
    a. are performed at the financial statement level only.
    b. provide information necessary to make planning decisions and judgments.
    c. do not include inspection or observation when performed in relation to audit planning.
    d. are not required when performing a compliance audit.
11. Which of the following statements best describes the five types of audit procedures and related activities identified in AU-C 300 and 315A?
    a. All five types are performed when obtaining an understanding of the entity and its environment.
    b. All five types are performed for every component of the understanding of internal control.
    c. Inquiry alone is sufficient for an auditor to obtain an understanding of internal control.
    d. If all the other types are performed, a discussion about the financial statements' susceptibility to material misstatement is not needed.
12. When making inquiries about fraud risks, which of the following questions might be directed to all employees selected during the audit of a HUD-assisted project?
    a. Do you understand what fraud is and can you provide an example or definition of fraud?
    b. How would reporting improved financial results help the project?
    c. How is management and/or the board compensated?
    d. How active is management in supervising the accounting department?
13. Which of the following statements best describes an auditor's use of observation and inspection during risk assessment and audit planning?
    a. Observation and inspection should not be performed during audit planning but saved until later in the engagement.
    b. Observation and inspection are often used to corroborate or follow-up on the results of inquiries.
    c. GAAP provides specific instructions as to when auditors should use observation and inspection instead of other risk assessment procedures.
    d. If there are differences, specific observation and inspection procedures are required to corroborate the client's explanations.

14. Which of the following matters is required to be covered in the engagement team discussion?
    a. Critical issues related to the audit and the entity's areas of significant risk.
    b. The implementation of any new accounting standards.
    c. How the audit may be affected by the use of IT.
    d. The application of GAAP to the entity's facts and circumstances in relation to its accounting policies.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

9. What is the term for an auditor's operational approach for achieving the objectives of an audit engagement? **(Page 308)**

   a. Audit plan. [This answer is incorrect. The *audit plan* is more detailed than the term described above. It documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence.]

   b. Audit program. [This answer is incorrect. An *audit program* is a lower level plan than the one defined above; therefore, there is a better answer to this question.]

   c. **Audit strategy. [This answer is correct. Planning an audit, according to AU-C 300.02, involves establishing the overall strategy for the engagement and developing an audit plan. The *audit strategy* is the auditor's operational approach to achieving the objectives of the audit. It is a high-level description of the audit scope, timing, and direction.]**

   d. Risk assessment. [This answer is incorrect. The *risk assessment process* involves performing procedures, obtaining an understanding of various matters about the entity and its environment, and making decisions and judgments about assessed risks and other matters based on that understanding. Auditors generally establish the approach described above before performing extensive risk assessment procedures.]

10. Risk assessment procedures— **(Page 309)**

    a. are performed at the financial statement level only. [This answer is incorrect. Risk assessment procedures are performed to obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at *both* the financial statement and relevant assertion levels.]

    b. **provide information necessary to make planning decisions and judgments. [This answer is correct. The information obtained by applying risk assessment procedures is used to make the important decisions and judgments that are part of audit planning. These decisions and judgments include determining materiality levels and assessing risks of material misstatement and material noncompliance.]**

    c. do not include inspection or observation when performed in relation to audit planning. [This answer is incorrect. Risk assessment procedures include inquiry, analytical procedures, inspection, and observation as well as related planning activities and procedures, such as preliminary engagement activities related to client acceptance and continuance, and holding a discussion among the engagement team.]

    d. are not required when performing a compliance audit. [This answer is incorrect. AU-C 935.15 extends the requirements to perform risk assessment procedures to a compliance audit. It states that the auditor should perform risk assessment procedures to obtain an understanding of applicable compliance requirements and internal control over compliance for each of the programs and compliance requirements selected for testing.]

11. Which of the following statements best describes the five types of audit procedures and related activities identified in AU-C 300 and 315A? **(Page 312)**

    a. **All five types are performed when obtaining an understanding of the entity and its environment. [This answer is correct. AU-C 300 and 315A specifically identify the following audit procedures and related activities as necessary risk assessment and other planning procedures: (1) preliminary engagement activities, including establishing an understanding with the client; (2) inquiries of management, internal audit (if applicable), and others within the**

entity and those charged with governance; (3) analytical procedures; (4) observation and inspection; and (5) discussion among the engagement team. All of these risk assessment procedures are performed when obtaining an understanding of the entity and its environment.]

b. All five types are performed for every component of the understanding of internal control. [This answer is incorrect. All of the audit procedures and related activities listed in AU-C 300 and 315A need *not* be performed for every component of the entity's internal control.]

c. Inquiry alone is sufficient for an auditor to obtain an understanding of internal control. [This answer is incorrect. The standards are explicit in indicating that inquiry alone is *not* sufficient to evaluate the design and implementation of internal control. Therefore, observation and inspection will most likely be coupled with inquiry procedures when obtaining the understanding of internal control.]

d. If all the other types are performed, a discussion about the financial statements' susceptibility to material misstatement is not needed. [This answer is incorrect. The discussion among the engagement team about the susceptibility of the entity's financial statements (including the individual statements and disclosures) to material misstatement is required by AU-C 315A.11. This requirement is not eliminated by performing all the other types of procedures.]

12. When making inquiries about fraud risks, which of the following questions might be directed to all employees selected during the audit of a HUD-assisted project? **(Page 319)**

a. **Do you understand what fraud is and can you provide an example or definition of fraud? [This answer is correct. Based on the recommendations provided in this course, this inquiry is one that might be directed to all employees selected for inquiries in relation to the audit of a HUD-assisted project. Another example of such an overarching question is "Does management make you aware of the importance of ethical behavior and appropriate business practices? If so, how?"]**

b. How would reporting improved financial results help the project? [This answer is incorrect. Based on the recommendations provided in this course, this question would typically be directed to employees in the leasing and marketing departments of a HUD-assisted project.]

c. How is management and/or the board compensated? [This answer is incorrect. This question, per the recommendations provided in this course, would be most appropriately directed to the human resources employees of a HUD-assisted project.]

d. How active is management in supervising the accounting department? [This answer is incorrect. This inquiry, as outlined in the recommendations of this course, would be best directed to employees of the accounting and finance department when auditing a HUD-assisted project.]

13. Which of the following statements best describes an auditor's use of observation and inspection during risk assessment and audit planning? **(Page 326)**

a. Observation and inspection should not be performed during audit planning but saved until later in the engagement. [This answer is incorrect. According to AU-C 315A.06, risk assessment procedures should include observation and inspection. There are a number of ways to use observation and inspection when assessing risk. When obtaining an understanding of the entity and its environment, observation or inspection might be the key procedure that enables the auditor to fully obtain pertinent information and identify related risks.]

b. **Observation and inspection are often used to corroborate or follow-up on the results of inquiries. [This answer is correct. Frequently, observation and inspection are used to corroborate or follow-up on the results of inquiries made of management and others. For example, when evaluating the design and implementation of the entity's system of internal control, members of management might tell the auditor that they communicate the importance of ethical values through a written code of conduct and by example. The auditor might wish to corroborate this response by examining the written code.]**

c. GAAP provides specific instructions as to when auditors should use observation and inspection instead of other risk assessment procedures. [This answer is incorrect. Determining when to use observation and inspection, as opposed to other risk assessment procedures, is generally a matter that is left to the auditor's judgment. Specific instructions are not found in the professional guidance that makes up GAAP.]

d. If there are differences, specific observation and inspection procedures are required to corroborate the client's explanations. [This answer is incorrect. In corroborating the explanations of differences, the auditor should consider the results of other audit procedures and the enhanced understanding of the client obtained during the audit. This information might be sufficient, and no additional evidence may be considered necessary.]

14. Which of the following matters is required to be covered in the engagement team discussion? **(Page 327)**

a. Critical issues related to the audit and the entity's areas of significant risk. [This answer is incorrect. To focus on the areas of vulnerability, the engagement team discussion might include topics such as critical issues and areas of significant audit risk. However, these are not matters that are specifically required.]

b. The implementation of any new accounting standards. [This answer is incorrect. The engagement team discussion might include a discussion on how the client implemented new accounting standards, but it is not required. It may not pertain to all clients or engagements.]

c. How the audit may be affected by the use of IT. [This answer is incorrect. Although not required, one area of focus during the engagement team discussion could be significant IT applications and how the use of IT may affect the audit. This topic will help the engagement team focus on areas of vulnerability.]

d. **The application of GAAP to the entity's facts and circumstances in relation to its accounting policies. [This answer is correct. Certain matters are required to be discussed during the engagement team discussion. These matters include the susceptibility of the entity's financial statements, including disclosures, to material misstatement and the application of GAAP to the entity's facts and circumstances in light of its accounting policies, among others.]**

Lesson 2: Obtaining an Understanding of the Entity, Its Environment, and Its Internal Control

INTRODUCTION

Lesson 2 continues the discussion of pre-engagement activities and audit planning for HUD audits by taking a look at how auditors obtain an understanding of a HUD-assisted entity and its environment. This discussion covers components of the understanding, the nature of the entity, fraud risk, and more.

Then, Lesson 2 concludes with a discussion of how auditors obtain an understanding of a HUD-assisted entity's internal control. This discussion includes the components of internal control, the elements of internal control (i.e., control environment, risk assessment, information and communication, and monitoring), understanding control activities, and performing tests of controls.

Learning Objectives:

Completion of this lesson will enable you to:

- Determine how auditors obtain an understanding of a HUD-assisted entity and its environment.
- Recognize how auditors obtain an understanding of a HUD-assisted entity's internal control.

OBTAINING AN UNDERSTANDING OF THE ENTITY AND ITS ENVIRONMENT

The auditor, according to AU-C 315A.05, should perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and relevant assertion level. AU-C 315A.03 explains that the objective of the auditor is to make this assessment by understanding the entity and its environment, including the entity's internal control, thereby providing a basis for designing and implementing responses to the assessed risks. This concept also applies in the compliance audit. It is necessary for the auditor to obtain an understanding of the project's HUD programs, and internal control over compliance related to those programs, to assess the risk of material noncompliance and to design the nature, timing, and extent of further compliance audit procedures. The general planning in a HUD audit engagement usually begins with obtaining a knowledge and understanding of the client's environment, including its internal control. The auditor's focus in obtaining the understanding should be on obtaining knowledge sufficient to develop an audit plan, including identifying significant audit areas, to assess the risk of material misstatement of the financial statements due to error or fraud, to assess the risk of material noncompliance relevant to HUD programs, and to design further audit procedures.

The auditor's process in obtaining this understanding for the financial audit is focused on those matters that could cause material misstatements in the financial statements, including potential fraud risk factors, undisclosed related-party transactions, violations of laws and regulations, uncertainties, or going-concern problems. The auditor's understanding of the entity also assists in:

- Establishing planning materiality and evaluating whether such judgments remain appropriate throughout the audit.
- Evaluating whether certain observed conditions, such as unusual or unexpected relationships from preliminary analytical procedures, do not make business sense and indicate possible risk considerations.
- Considering fraud risk factors.
- Evaluating the appropriateness and sufficiency of audit evidence.

In the compliance portion of the HUD audit of major programs, the auditor is required to perform procedures to obtain an understanding of internal control over compliance that is sufficient to plan the audit and test internal control over compliance. To do so, the auditor needs to understand the assertions relevant to the compliance requirements for the project's major HUD programs. Obtaining this knowledge allows the auditor to understand both the design of relevant controls pertaining to each of the five internal control components (i.e., control environment, risk assessment, control activities, information and communication, and monitoring) and whether they have been placed in operation. The auditor obtains this knowledge through inquiries of client management and other personnel, inspection of documents and records, and observation of activities and operations, as well as through previous experience with the client. The auditor should assess not only the risk of noncompliance with HUD program requirements, but also the risk that noncompliance may cause a material misstatement of the financial statements. The HUD audit guide, Paragraph 1-3(B), establishes a requirement for audit documentation to clearly demonstrate the auditor's understanding and assessment of control risk related to internal controls over compliance for HUD-assisted activities.

In a continuing engagement, the auditor updates knowledge of the HUD-assisted project, its business environment, and HUD and other regulatory developments, by focusing on identifying changes from the prior year in internal or external conditions that might be of audit significance and affect the entity's business risk or the auditor's assessment of audit risk.

Components of the Understanding

AU-C 315A.12 indicates that the auditor's understanding of the entity and its environment consists of an understanding of the following items:

a. Industry, regulatory, and other external factors.

b. Nature of the entity.

c. Objectives, strategies, and related risks that may result in a material misstatement or noncompliance.

d. Measurement and review of the entity's financial performance.

e. Selection and application of accounting policies.

In addition, the consideration of fraud risk factors is an important objective of performing risk assessment procedures. Although considering the presence of fraud risk factors occurs simultaneously with obtaining information about the entity and its environment, it merits separate and focused attention.

Documentation. AU-C 315A.33 indicates that auditors should document:

- Key elements of the understanding obtained for each of the aspects of the entity and its environment.
- Sources of the information from which the understanding was obtained.
- Risk assessment procedures that were performed.

AU-C 240 requires auditors to document their consideration of fraud risk factors. According to AU-C 935, the documentation requirements of AU-C 240 and AU-C 315A should be adapted and applied in a compliance audit.

The documentation for a HUD entity may also include the following:

- The HUD handbooks that apply to the current audit.
- Changes in HUD or other governmental funding policies.
- Changes in HUD or other governmental regulations.
- The type of project the entity operates [Section 8 rent subsidy, Section 221(d)(3) insured loan project, etc.].
- If the project owner employs a management agent, the extent of its responsibilities and the extent of control the project owner exercises over the management agent's activities.

- The project owner's policies, HUD requirements, and methods for funding the replacement reserve, residual receipts account, and any other types of reserves.

The auditor should also document the major programs tested as part of the compliance audit. For-profit HUD entities, determine major programs based on the guidance in the HUD audit guide. Nonprofit HUD entities determine major programs based on the guidance in the Uniform Guidance.

Purpose of This Section. The following paragraphs provide a detailed discussion of each of the aspects of the entity and its environment that the auditor is required to understand. Procedures the auditor may perform to gain that understanding and the types of risks the auditor may identify throughout that process are also discussed.

Industry, Regulatory, and Other External Factors

AU-C 315A.12 indicates that the auditor should obtain an understanding of industry, regulatory, and other external factors relevant to the audit. The objective of the auditor's understanding is to evaluate whether the entity is subject to specific risks of material misstatement arising from the nature of the industry, the degree of regulation, or other external forces, such as political, economic, social, technological, or competitive forces.

AU-C 315A.A26–.A30 indicate that the auditor might consider factors such as the following when obtaining an understanding of industry, regulatory, or other external factors:

a. Industry conditions, including market and competition, economic or demographic changes, cyclical or seasonal rental activity, local housing trends, societal attitudes, tax laws or rate changes, and changes in government funding policies.

b. Regulatory environment, including relevant legislation and regulation, environmental requirements, specific regulatory requirements, direct supervisory activities, and taxation.

c. Government policies, including monetary, fiscal, financial incentives, and tariffs or trade restrictions.

d. Other external factors, including the general level of economic activity, unemployment, interest rates, availability of credit, and inflation.

Risk Assessment Procedures and Factors to Consider. The authors believe, in most situations, auditors will initially gather information and identify risks related to industry, regulatory and other external factors through inquiry procedures. Many of the matters to be addressed are best approached through inquiry of appropriate client management and other employees. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

The most common high-risk areas for HUD entities will be those accounts associated with HUD funding requirements. Common examples of areas that might be high risk, depending on the entity include the following:

- Complying with HUD requirements.
- Recognizing revenue under different HUD programs.
- Complying with debt or funding covenants.

Since the entity's financial statements are used to demonstrate compliance with HUD regulations, there is a greater risk to the auditor. The auditor should evaluate this risk and plan an appropriate audit response.

As discussed in Lesson 1, the auditor might supplement inquiry procedures with inspection or other risk assessment procedures. For example, when obtaining an understanding of the industry and environment, the auditor might read *PPC's Guide to HUD Audits*, which is updated annually, AICPA accounting and auditing guides, industry publications, HUD publications, proposed legislation that may affect the client, financial statements of other HUD entities, textbooks, or trade journals, or might subscribe to services that provide an in-depth analysis of the HUD-assisted multifamily housing industry. HUD's website and the AICPA GAQC webpage dedicated to HUD developments are important sources of information about regulatory developments for auditors.

Nature of the Entity

AU-C 315A.12 indicates that the auditor should obtain an understanding of the nature of the entity relevant to the audit. The nature of the entity includes its operations; its ownership and governance; its HUD programs and its controls over these programs, the types of its existing and future investments; and its structure and financing. Among other things, the understanding of the nature of the entity helps the auditor to understand the classes of transactions, account balances, and disclosures that would be expected in the financial statements. The auditor also learns about the characteristics of the entity's structure and associated risks. For example, an entity may have a complex structure with subsidiaries, other components, or multiple locations. Complex structures often give rise to risks of material misstatement, such as whether the entity has applied appropriate accounting for goodwill, joint ventures, equity investments, and consolidations. In addition, entities with complex structures often have special audit implications such as the requirements for audits of group financial statements. Furthermore, by understanding the nature of the entity, the auditor learns of the ownership and relationships between the owner and other related parties. As noted in AU-C 550, *Related Parties*, the nature of related parties and transactions may, in some circumstances, give rise to higher risks of material misstatements or noncompliance.

Matters that the auditor might consider about the entity's operations; its organizational structure, ownership, personnel, and governance; and its investments and financing include the following:

a. Revenue sources.

b. Key subsidy programs.

c. Conduct of operations.

d. Important suppliers.

e. Major assets and liabilities.

f. Major expenses.

g. Employment and human resource matters, including compensation methods and employee benefits.

h. The project's major sources of financing (i.e., insured or coinsured loans, capital advances, flexible subsidy loans, equity).

i. The contracts and agreements that have audit significance, e.g., HAP contracts, regulatory agreements, management entity profile, management agent certification, loan agreement, capital advance agreement, etc.

j. Related parties and transactions with them.

k. Location of project and layout of buildings.

l. Types of investments.

m. Financing activities.

Operating Characteristics. The auditors should identify the entity's major revenue sources (for example, tenant rent payments, rent subsidies, etc.), major operating expenses, and financing sources. The auditor should also identify HUD requirements for funding the replacement reserve and residual receipts accounts. Because rental revenue is generally a significant transaction class, the auditor will normally place emphasis on understanding matters related to leasing activities, subsidy programs if any, and revenue recognition. Matters that the auditor might consider about investments and financing depend on the relative importance of those activities.

Organizational Structure and Personnel. Auditors should obtain an understanding of the project's legal structure and type of legal entity by reviewing the entity's governing documents. Auditors should identify key management members and the accounting staff. The auditor ought to also identify partners (or shareholders) and their percentage ownership interest in the project and obtain an understanding of how profits and losses are allocated.

It is relatively common for a project owner to use a management agent for various administrative and financial functions. Auditors should gain an understanding of the extent of the management agent's responsibilities and the degree of control the project owner exercises over the management agent's activities. If the project owner has its own employees, the auditors should obtain an understanding of the nature and size of the work force and its compensation methods.

Governing Documents and Similar Documents. The governing documents mentioned above are the legal documents that create the HUD entity or stipulate how it should be operated under HUD regulations. Either obtaining copies of key agreements or preparing memoranda summarizing their key provisions provides helpful information. Most HUD projects have agreements for the following:

- *Formation of the Entity.* Rarely are HUD entities proprietorships. Most are formed as corporations or limited partnerships. Corporations have articles of incorporation and bylaws, and partnerships have partnership agreements.
- *Regulatory Agreement.* HUD exercises control over the entity through the Regulatory Agreement. The agreement is signed by HUD and the project owner and addresses a variety of administrative and compliance requirements.
- *Affirmative Fair Housing Marketing Plan.* HUD regulations require project owners to market their properties without regard to the race, color, religion, sex, or national origin of prospective tenants. An "Affirmative Fair Housing Marketing Plan," prepared by the owner and approved by HUD, describes the methods used to market the project, for example, classified ads, and includes the owner's promise to make special efforts to attract tenants who are least likely to apply for the housing.
- *Management Agreement.* If the project has engaged a management agent, the management agreement will set forth the management agent's responsibilities and the management fee.
- *Management Entity Profile.* This must be completed by the management agent and submitted to the HUD field office. The document describes the management agent's ownership structure, operating procedures, and the types of HUD projects it manages. A new profile must be submitted whenever there have been significant changes in the agent's organization or operations.
- *The Housing Assistance Payments (HAP) Contract.* Many HUD projects are participants in one or more rent subsidy programs. The HAP contracts set forth the rights and duties of the project owner and the contract administrator under the subsidy program.

Audit Committees. Many entities have established either an audit committee or a group of individuals formally designated with oversight of financial reporting. Auditors should determine whether there is such a group to which inquiries should be directed and communications made. *Government Auditing Standards*, as well as several AICPA auditing standards, have established requirements for auditor communication with audit committees (or others charged with governance). Those requirements are discussed throughout this course where relevant.

HUD Correspondence. The auditors ought to review all of the correspondence the owner received from HUD since the previous year's audit. Correspondence since inception of the project ought to be reviewed for new audit engagements. Typical correspondence includes inspection reports and management reviews. The correspondence can provide valuable information about HUD's view of the project and its management as well as items of direct audit significance.

Identifying HUD Programs and Applicable Compliance Requirements. AU-C 935.14 clarifies that management is responsible for identifying an entity's government programs and understanding and complying with their compliance requirements. However, the auditor determines which government programs and compliance requirements to test (i.e., the applicable compliance requirements). In a compliance audit of a for-profit HUD-assisted multifamily entity, the applicable compliance requirements are specified in Chapter 3 of the HUD audit guide. In the audit of a nonprofit HUD-assisted entity, the OMB Compliance Supplement provides the framework for determining compliance requirements subject to audit. (For federal award programs included in the Compliance Supplement, the concept of applicable compliance requirements was replaced with compliance requirements that are subject to audit.)

Identifying Major Programs. In a HUD audit, the auditor is required to express an opinion on compliance with requirements applicable to major HUD programs when HUD program assistance meets the applicable threshold. Thus, an early planning consideration is determining whether the client received HUD assistance under one or more HUD programs that meet the criteria for major programs.

Related Parties. Auditors should also identify known related parties and obtain copies of related agreements such contracts and leases. Auditors should review documents in the permanent file, inquire of management, and review minutes and other records and documents considered necessary in the circumstances to identify transactions with related parties. Also, auditors should consider whether related party transactions have occurred but are not recognized in the accounting records. (For example, the project owner's accounting personnel might be used to process transactions for another entity.) The names of known related parties should be communicated to the engagement team at the start of the audit so they can identify and examine related-party transactions in applicable audit areas. Auditors should update the list of related parties throughout the engagement and communicate changes to all engagement team members.

Often the best way to become aware of related party transactions is through inquiries of the project owner and management, and review of minutes.

Risk Assessment Procedures and Factors to Consider. Similar to the understanding of industry, regulatory and other external factors, the auditor often initially makes inquiries of appropriate client personnel about matters pertaining to the nature of the entity. To make effective risk-based inquiries, it is critical that the auditor identify the right person within the entity who possesses not only the requisite knowledge about the matter queried, but also about the nature of risks, how the entity has addressed them, and what the remaining risk is to the entity. In an audit of a HUD-assisted project, auditors may consider interviewing, for example, the president or managing partner, the controller or treasurer, and/or the current managing agent if applicable.

The auditor's inquiries may be supplemented by additional inquiries as deemed necessary to fully understand the nature of the entity so that related risks can be identified. This understanding provides the auditor with an expectation of what classes of transactions, account balances, and disclosures will be present in the financial statements. The auditor may need to expand inquiries based on the client's responses to more fully understand the area and follow up on information that may be indicative of a potential risk.

Objectives, Strategies, and Related Business Risks

AU-C 315A.12 indicates that the auditor should obtain an understanding of the entity's objectives, strategies, and related business risks. The basic concept here is that most business risks eventually have financial or compliance consequences and, thus, an effect on the financial statements or program compliance. Not all business risks create risks of material misstatement or noncompliance, so the auditor needs to focus on those risks that have implications in the entity's particular circumstances.

The auditor obtains an understanding of management's objectives and strategies to identify the related business risks. Management and those charged with governance determine the entity's objectives, which include the overall plans for its HUD programs. Management's strategies are the operational approaches adopted to achieve the objectives. The related business risks are the significant conditions, events, circumstances, actions, or inactions that could adversely affect the entity's ability to achieve its objectives or implement its strategies. When obtaining an understanding of the entity's objectives and strategies, it is often helpful to consider whether strategies align with objectives and if strategies have been implemented. By doing so, the auditor may become aware of heightened or additional business risks and potential risks of material misstatement or noncompliance.

When identifying relevant business risks, the auditor needs to be alert for changes in the client's business strategies as well as new operational complexities that may result in business risk. It also is important to consider changes in external or internal conditions for which the client does not adopt an appropriate strategy, such as a shift in the need for HUD multifamily housing.

Risk Assessment Procedures and Factors to Consider. When obtaining an understanding of management's objectives and strategies to identify the related business risks, the risk assessment procedures employed by the auditor may be influenced by the size and sophistication of the entity. Smaller HUD projects may not have formal plans or processes that are documented, forcing the auditor to rely primarily on inquiries. When making inquiries, the auditor will generally restrict questioning to upper management given the subject matter and the level of knowledge that is needed to sufficiently address it. These inquiries would prompt management to describe the entity's future trends, expectations, objectives, and strategies in areas such as the following:

- Industry or regulatory developments.
- Rental policies and assistance programs.
- Marketing and leasing.
- Technology.
- Business expansion or restructuring.
- Financing requirements.
- Human resources.

Measurement and Review of the Entity's Financial Performance

AU-C 315A.12 indicates that the auditor should obtain an understanding of the measurement and review of the entity's financial performance made by management and external parties. Information used for measurement and review might include the following:

a. Key performance indicators, both financial and nonfinancial.
b. Trends.
c. Key ratios and other operating and financial statistics.
d. Forecasts, budgets, and variance analyses.
e. Period-on-period financial performance.
f. Employee performance measures.
g. Subsidiary, division, department, or other performance reports.
h. Comparisons to performance of comparable entities (i.e., benchmarking).

Information prepared by external parties might include HUD inspection reports and management reviews.

Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement in several ways, including the following:

a. The pressure to meet performance targets could motivate management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment.
b. Use of performance measures might highlight unexpected results or trends, which upon investigation result in detection of misstatements.
c. The auditor might be able to use key performance indicators or other measures used by management when performing analytical procedures. However, the auditor needs to consider whether the information used by management is reliable and provides the degree of precision that is needed for the analytical procedures.

Risk Assessment Procedures and Factors to Consider. Management often identifies key financial performance indicators that it uses when managing the HUD-assisted project but it may not prepare formal reporting or analyses other than those required by HUD. As management reviews financial or other operating reports, a determination is made whether the project has achieved the targets that management has established for these indicators. For these situations, the auditor would likely use inquiry to determine what indicators management believes are important in managing and measuring the project's results along with the reports that are used to monitor performance.

The auditor inquires about external measurement of the entity's financial and management performance such as by HUD and lenders. If so, the auditor may review available reports to identify potential risks.

Selection and Application of Accounting Policies

AU-C 315A.12 states that the auditor should obtain an understanding of management's selection and application of accounting policies and evaluate whether the policies are appropriate for the entity and consistent with policies used by HUD-assisted projects. Further, AU-C 540A.08 indicates that the auditor should obtain an understanding of the following regarding accounting estimates:

- Requirements of GAAP relevant to the accounting estimates, including those related to disclosures.
- How management identifies transactions, events, and conditions that may give rise to accounting estimates.
- How management makes accounting estimates and the data on which estimates are based, including—
    - Methods used, including models if applicable.
    - Relevant controls.
    - Whether a specialist was used.
    - Assumptions underlying accounting estimates.
    - Any changes in methods or assumptions made, or that ought to have been made, from the prior period and reasons for those changes.
    - Whether and how management has assessed the effect of estimation uncertainty.

Gaining an understanding of the selection and application of accounting policies and accounting estimates is important for considering the risks of material misstatement at both the financial statement and relevant assertion levels, including both misstatements due to fraud and those due to error. The auditor's assessment of the appropriateness of the accounting policies that management has selected and applied is an important element in determining what can go wrong in the preparation of financial statements and, hence, in assessing risks of material misstatement. For a HUD-assisted project, significant accounting policies include those for recognition of rental income, asset valuation, investments, loan amortization, and interest accrual.

The auditor is also required to perform a review of the outcome of accounting estimates that were included in the prior period. Generally, the outcome of an accounting estimate will differ from the amount that was recognized in the prior period. By identifying and understanding the reasons for such differences, the auditor may obtain information about the effectiveness of management's prior period estimation process, audit evidence that is pertinent to re-estimation of prior period estimates in the current period, or evidence of matters requiring disclosure in the financial statements such as estimation uncertainty. In addition, AU-C 240, *Consideration of Fraud in a Financial Statement Audit*, requires a retrospective review of management's judgments or assumptions related to significant accounting estimates included in prior period financial statements to determine if there is an indication of management bias and a risk of material misstatement due to fraud. As a practical matter, both reviews can be coordinated when reviewing prior period estimates.

The auditor's understanding of management's selection and application of accounting policies includes the following:

a. Relevant accounting standards, industry specific practices, and HUD financial reporting requirements.
b. The methods the entity uses to account for significant and unusual transactions.

c. The effect of significant accounting policies in controversial or emerging areas for which there is a lack of authoritative guidance or consensus.

d. Changes in the entity's policies, including the reasons for the change and whether the change is appropriate and consistent with GAAP.

e. Reporting standards and regulations that are new to the entity and management's plans to adopt such requirements, including new accounting standards or regulatory requirements.

f. The process used by management in formulating particularly sensitive accounting estimates.

g. The methods used to identify matters for disclosure and how the entity achieves clarity in disclosure.

The auditor uses the understanding of these aspects of management's selection and application of accounting policies to identify audit areas of higher risk and to identify what could go wrong at the relevant assertion level. For example, if the entity has to apply a relatively complex accounting standard to a new type of significant unusual transaction there ordinarily is a higher risk of material misstatement for the account balance affected.

The auditor uses the understanding of management's selection and application of accounting policies along with the identification of fraud risk factors to evaluate whether an overall response is necessary. AU-C 240.29 indicates that in determining overall responses to fraud risk, the auditor should evaluate whether the selection and application of accounting policies, particularly policies related to subjective measurements and complex transactions, may be indicative of—

- Fraudulent financial reporting to manage earnings.
- Bias that may create a material misstatement.

AU-C 240.A41 observes that management bias in the selection and application of accounting principles may individually or collectively involve matters such as the following:

- Contingencies.
- Fair value measurements.
- Revenue recognition.
- Accounting estimates.
- Related party transactions.
- Transactions without a clear business purpose.

In establishing the overall audit strategy, the auditor focuses on whether the accounting principles selected and policies adopted are being applied in an inappropriate manner. If the auditor identifies a risk in this area, it is often addressed by an overall response, such as the assignment of more experienced personnel and a higher level of supervision, as well as by the selection of specific further audit procedures.

Risk Assessment Procedures. The nature and extent of the risk assessment procedures to obtain an understanding of the selection and application of accounting policies normally depend on factors such as:

- The auditor's knowledge and experience with the HUD-assisted multifamily housing industry.
- The auditor's knowledge and past experience with the client.
- The degree of financial reporting sophistication of the client.
- The extent of new accounting standards that are recently effective for the client.
- The auditor's participation in assisting the client with the selection of accounting policies and the preparation of the financial statements.

Although management is responsible for selecting the entity's accounting principles, for many HUD clients, the auditor is instrumental in assisting with their selection and advising on the methods by which they are applied. Consideration of accounting policies for those clients ordinarily will not be a time-consuming process since the auditor already possesses much of the requisite knowledge. The auditor in those cases can generally confine inquiries of the client to matters such as the manner and consistency of application. For other situations where the auditor is not involved in the selection of accounting policies or has limited experience with the client, the auditor may inquire about management's selection and application of accounting policies. Also, the auditor may supplement inquiries with a review of prior year financial statements and supporting disclosures (for initial audits) coupled with a thorough review and understanding of relevant accounting standards that are either new or specifically applicable to the multifamily real estate industry or its transactions.

Measurement and Review of HUD Program Performance

The auditor should obtain an understanding of the measurement and review of HUD program performance made by management and external parties. Information used by management for measurement and review relevant to the HUD audit might include program or other internally prepared reports, or reports received from regulatory agencies.

Performance measures can affect the audit and the auditor's assessment of the risks of material misstatement or noncompliance in several ways, including the following:

a. The pressure to meet performance targets or comply with program requirements could motivate management actions, including intentional misstatements, and, thus, affect the auditor's risk assessment.

b. Use of performance measures might highlight unexpected results or trends, which upon investigation result in detection of misstatements or noncompliance.

Risk Assessment Procedures and Factors to Consider. The procedures used by the auditor for understanding the measurement and review of HUD program performance will often be driven by the size and sophistication of the entity. Management may have identified key performance indicators that it uses. For these situations, the auditor would likely use inquiry to determine what indicators management believes are important in managing and measuring the entity's results and inspect the reports that are used to monitor performance and compliance.

For all situations, the auditor considers inquiring about external measurement of program performance and reviewing available reports to identify potential risks.

New Accounting Standards

Auditing standards emphasize the importance of consideration of an entity's implementation of new accounting standards in obtaining an understanding of the entity, assessing risks of material misstatement, and planning the audit. The Appendix at AU-C 300.A27 identifies significant changes in the financial reporting framework, such as changes in accounting standards, as a significant factor to be considered in establishing the overall audit strategy. AU-C 315A.A36 explains that an understanding of the entity's selection and application of accounting policies includes financial reporting standards new to the entity and when and how it will adopt those requirements. Of particular importance, AU-C 315A.29b requires the auditor to consider whether the risk related to significant accounting developments is a significant risk necessitating special audit consideration. As part of risk assessment procedures and planning, an auditor needs to identify new accounting standards that the entity is required or has elected to adopt in the current period, and consider how the new standards and the method of their implementation affect the risks of material misstatement.

Among the important considerations that affect risk assessment and planning when an entity has adopted a new accounting standard are the following:

a. *Discuss in advance*. Before the period in which the new accounting guidance is implemented, discuss with management the changes in accounting policies and procedures, controls, and personnel that may be necessary.

b. *Evaluate adequacy of personnel*. The accounting personnel who were able to prepare financial statements in prior periods adequately may be challenged by the new accounting guidance. (An auditor may want to recommend additional training, additional personnel, or engaging a consultant.)

c. *Allow more time*. The risk assessment and planning step in the audit may require more time than in prior periods that had no changes in accounting principle.

d. *Focus on the transition*. Consider the additional steps that may be needed by management and in the audit to deal with transition requirements, including gathering required information and putting controls over the transition in place.

e. *Consider the effect of changes in controls*. New controls, or amendments of existing controls, may be necessary to ensure compliance with new accounting requirements. Requirements for new significant judgments, methods, and assumptions, particularly related to new estimates, may require new controls. Also, the absence of changes when needed will increase risks.

f. *Consider the effect changes in measurement of account balances may have*. If implementation of the new accounting standard causes the amount of account balances to change from what they would have been under prior guidance, there may be significant changes in the materiality benchmark, amounts used in analytical procedures, and key performance indicators.

Leases Under FASB ASC 842. FASB ASC 842, *Leases*, is effective for entities other than public business entities for fiscal years beginning after December 15, 2021 and supersedes prior guidance on accounting for leases. Under the new standard, lessor accounting remains largely the same as under FASB ASC 840, particularly for operating leases.

ASU 2016-13, *Financial Instruments—Credit Losses (Topic 326): Measurement of Credit Losses on Financial Instruments*, is effective for entities other than public business entities for fiscal years beginning after December 15, 2022, including interim periods within those fiscal years. Current GAAP for credit losses is based on an incurred loss methodology that delays recognition of a credit loss until it is probable that a loss has been incurred. ASU 2016-13 replaces the incurred loss impairment methodology with one that reflects expected credit losses and does not prescribe the method for measuring expected credit losses. The new standard provides financial statement users with improved information about expected credit losses on financial assets and commitments to extend credit.

Auditors need to consider all the matters relevant to FASB ASC 842, and *ASU 2016–13,* as applicable, during the period of implementation. An auditor's identification and assessment of risks of material misstatement need to include new risks applicable to the transition period and subsequently. Management may be making new judgments and estimates that increase the risk of both error and fraud. If revenue has been used as a benchmark, materiality judgments may be affected. Changes in controls may require additional time to obtain an understanding and evaluate design and implementation, and cause risk assessments to change.

Fraud Risk Factors

Fraud risk factors are events or conditions that indicate an incentive or pressure to perpetrate fraud, provide an opportunity to commit fraud, or indicate attitudes or rationalizations to justify a fraudulent action. AU-C 240.24 states that the auditor should evaluate whether the information obtained from risk assessment procedures indicates that one or more fraud risk factors are present.

The identification of fraud risk factors is a natural by-product of performing risk assessment procedures. Along with the other information obtained about the entity and its environment, the fraud risk factors are an important component in identifying the risks of material misstatement at the financial statement and relevant assertion levels, and noncompliance. The auditor's primary concern in considering fraud risk factors is to identify whether a risk factor is present and needs to be considered in identifying and assessing risks of material misstatement or material noncompliance due to fraud. The presence of a particular fraud risk factor does not necessarily indicate the existence of fraud. Whether a risk factor is present and needs to be considered in identifying and assessing the risks of material misstatement or material noncompliance due to fraud is a matter of professional judgment.

Examples of Fraud Risk Factors. AU-C 240.A76 provides examples of fraud risk factors that may be considered when identifying and assessing the risks of material misstatement due to fraud. The risk factors are classified into factors related to fraudulent financial reporting and factors related to misappropriation of assets. Because it may be helpful to consider fraud risk factors in the context of the conditions generally present when fraud occurs, the illustrative risk factors are further classified into conditions relating to incentives/pressures, opportunities, and attitudes/rationalizations. It is important to note that these are only examples and the auditor also may consider other risk factors not specifically listed.

Auditor's Considerations of Fraud Risk Factors. For misappropriation of assets, the consideration of fraud risk factors is influenced significantly by the HUD audit guide's and the Yellow Book's emphasis on reporting noncompliance and fraud. Consideration is given to risk factors related to incentives/pressures, opportunities arising from control deficiencies, and attitudes/rationalizations for misappropriation, even if assets susceptible to misappropriation are not material. One of the primary fraud risks in HUD entities is fraudulent cash disbursements, in which case there is always an asset subject to misappropriation. Also, cash collected at the leasing office and property that is easily convertible to cash are examples of items that are easily stolen. The auditor should identify those items that employees can misuse at the entity's expense. In addition, invoices from vendors may be inflated, requiring the entity to pay more for services than prices originally agreed upon. When considering risk factors for misappropriation, the auditor may identify risk factors related to inadequate monitoring and weaknesses in internal control that could also be present when fraudulent financial reporting or noncompliance occurs.

The presence of risk factors related to financial stress or dissatisfaction among employees is particularly important when considering the risk of misappropriation of assets because those conditions often provide both incentive and rationalization for theft. The auditor, during the course of the audit, may become aware of information that indicates potential financial stress or dissatisfaction of employees with access to assets susceptible to misappropriation. Examples include:

- Expected or rumored changes in property management, for example expiration of the management agent's contract.
- Abusive or overbearing management coupled with unreasonable expectations.
- Anticipated layoffs that are known to employees.
- Unfavorable changes in employee compensation or benefit plans.
- Failure to receive promotions or other expected rewards.
- Unusual changes in behavior or lifestyle.
- Employees who are known to be experiencing significant personal financial obligations.
- Behavior indicating dissatisfaction with the project owner or management, including disregard for the entity's policies and procedures.

If the auditor becomes aware of the presence of these or similar risk factors, he or she considers them when identifying the risks of material misstatement and material noncompliance due to fraud.

As noted above, for many HUD entities, one of the primary fraud risks is fraudulent, unauthorized disbursements (for example, bookkeepers writing checks to themselves). Many HUD-assisted projects are susceptible to such fraud because of a lack of segregation of duties. If the auditor concludes there is a risk that such disbursements may occur in amounts that could result in material misstatement of the financial statements, an audit response is required by GAAS. Substantive tests of the cash balance recorded in the financial statements may not be sufficient to respond to a material risk of fraudulent cash disbursements. Other audit procedures may be required to respond to the risk of material misstatement of the financial statements due to fraud. The auditor should also consider the requirements for the compliance portion of the HUD audit when responding to identified fraud risks.

Presumption of Revenue Recognition as a Fraud Risk. Material misstatement of the financial statements due to fraudulent financial reporting often results from improper revenue recognition. Revenue may be overstated, such as by recording fictitious leases or recognizing revenue before it is earned, or understated, such as by shifting revenue to a later period. Therefore, AU-C 240.26 requires auditors to make the rebuttable presumption that improper revenue recognition is a risk of material misstatement of the financial statements due to fraud and to evaluate which types of revenue, revenue transactions, or assertions are affected by the risks. Consider which types of revenue, revenue transactions, and assertions give rise to the risk of improper revenue recognition due to fraud. Risks of material misstatement due to fraud are always significant risks. The Observations and Suggestions at paragraph 5.31 of the AICPA Risk Assessment Audit Guide state that significant risks are those with inherent risk that is "higher than the usual high," thus requiring special attention in the audit. Therefore, the author's believe that the presence of fraud risk qualifies revenue as significant audit area, as described in Lesson 3.

While the presumption that improper revenue recognition is a fraud risk, and the accompanying designation of revenue as a significant audit area, may be overcome in some GAAS audits, the authors believe this would be unlikely in a HUD audit engagement. The authors believe affirmative reasoning and an evaluation of observed fraud conditions, rather than negative reasoning (such as "nothing came to our attention"), are needed to overcome the presumption. If the auditor lacks an affirmative reason to overcome the presumption that revenue recognition is a fraud risk, or if the auditor has observed the presence of fraud conditions related to improper revenue recognition, he or she evaluates that information with a heightened awareness of the need to identify improper revenue recognition as a fraud risk. Because revenue is material to the financial statements of HUD entities, if there are one or more indications of potential improper revenue recognition gathered during the risk assessment process, the authors believe the auditor ordinarily will not be able to overcome the presumption. If improper revenue recognition is not identified as a risk of material misstatement of the financial statements due to fraud, the auditor is required by AU-C 240.46 to document the reasons supporting that conclusion.

Auditor's Response to Fraud Risk Factors. If fraud risk factors are present in accordance with AU-C 330, AU-C 240.28, and AU-C 240.30, the auditor considers whether the assessment of the risk of material misstatement or noncompliance due to fraud calls for an overall response, one that is specific to a particular account balance, class of transaction, or disclosures at the relevant assertion level, or both. An overall response is considered in establishing the overall audit strategy and a specific response is considered in developing the detailed audit plan.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

15. Which of a HUD entity's governing documents sets forth the rights and duties of the project owner and the contract administrator under a rent subsidy program?

    a. The Affirmative Fair Housing Marketing Plan.

    b. The Housing Assistance Payments (HAP) contract.

    c. The Management Entity Profile.

    d. The Regulatory Agreement.

16. The Dragonfly Apartments, a HUD entity, will be affected by a new accounting standard. What guidance will help Luke, the head of the Dragonfly's audit team, address this for risk assessment and audit planning purposes?

    a. He should not address the new accounting standard until after it has been implemented into the Dragonfly's financial system.

    b. He should budget less time for the audit after the new accounting standard has gone into effect.

    c. He should consider additional steps that may be needed to deal with the requirements of transitioning to the new accounting standard.

    d. He should make sure the Dragonfly assigned the same staff members to prepare its financial statements as in prior years.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

15. Which of a HUD entity's governing documents sets forth the rights and duties of the project owner and the contract administrator under a rent subsidy program? **(Page 341)**

    a. The Affirmative Fair Housing Marketing Plan. [This answer is incorrect. HUD regulations require project owners to market their properties without regard to race, color, religion, sex, or national origin of prospective tenants. An "Affirmative Fair Housing Marketing Plan," prepared by the owner and approved by HUD, describes the methods used to market the project, for example, classified ads, and includes the owner's promise to make special efforts to attract tenants who are least likely to apply for the housing.]

    b. **The Housing Assistance Payments (HAP) contract. [This answer is correct. The governing documents are the legal documents that create the HUD entity or stipulate how it should be operated under HUD regulations. One governing document that most HUD projects have is the HAP contract. Many HUD projects are participants in one or more rent subsidy programs. The HAP contracts set forth the rights and duties of the project owner and the contract administrator under the subsidy program.]**

    c. The Management Entity Profile. [This answer is incorrect. This must be completed by the management agent and submitted to the HUD field office. The document describes the management agent's ownership structure, operating procedures, and types of HUD projects it manages. A new profile must be submitted whenever there have been significant changes in the agent's organization or operations.]

    d. The Regulatory Agreement. [This answer is incorrect. HUD exercises control over the entity through the Regulatory Agreement. The agreement is signed by HUD and the project owner and addresses a variety of administrative and compliance requirements.]

16. The Dragonfly Apartments, a HUD entity, will be affected by a new accounting standard. What guidance will help Luke, the head of the Dragonfly's audit team, address this for risk assessment and audit planning purposes? **(Page 346)**

    a. He should not address the new accounting standard until after it has been implemented into the Dragonfly's financial system. [This answer is incorrect. Luke should consider discussing the new standard *in advance*. Before the period in which the new accounting guidance is implemented, he can discuss with management the changes in accounting policies and procedures, controls, and personnel that may be necessary.]

    b. He should budget less time for the audit after the new accounting standard has gone into effect. [This answer is incorrect. Instead, Luke should allow *more* time. The risk assessment and planning step in the audit may require more time than in prior periods that had no changes in accounting principle.]

    c. **He should consider additional steps that may be needed to deal with the requirements of transitioning to the new accounting standard. [This answer is correct. One important consideration Luke should make in this situation is to focus on the transition. He should consider the additional steps that may be needed by management and in the audit to deal with transition requirements, including gathering required information and putting controls over the transition in place.]**

    d. He should make sure the Dragonfly assigned the same staff members to prepare its financial statements as in prior years. [This answer is incorrect. Instead, Luke should evaluate the adequacy of personnel. The accounting personnel who were able to prepare financial statements in prior periods adequately may be challenged by the new accounting guidance. An auditor may want to recommend additional training, additional personnel, or engaging a consultant.]

OBTAINING AN UNDERSTANDING OF INTERNAL CONTROL

In a HUD audit engagement, obtaining an understanding of internal control encompasses two elements; (a) obtaining an understanding of controls pertaining to financial statement assertions, and (b) obtaining an understanding of controls pertaining to compliance with the requirements for HUD programs. AU-C 315A.13–.25 establishes requirements for auditors related to consideration of internal control as part of an audit. It also provides guidance about how the entity's use of information technology (IT) affects the auditor's consideration of internal control in planning the audit. Auditors should obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. That understanding needs to incorporate knowledge about controls relevant to compliance with laws and regulations that have a direct and material effect on the determination of financial statement amounts. Considerations for obtaining the understanding of controls over compliance for HUD programs are discussed later in this section.

Components of Internal Control

AU-C 315A.15–.25 requires an understanding of five interrelated components of internal control. These five components, which are also defined and described in more detail in COSO's *Internal Control—Integrated Framework*, are as follows:

a. Control environment

b. Risk assessment

c. Information and communication

d. Monitoring

e. Control activities

AICPA Technical Question and Answer, *Obtaining an Understanding of Internal Control Relevant to the Audit* (Q&A 8200.18), points out that the AU-C 315A requirement to obtain an understanding of internal control relevant to the audit applies to each of the five components of internal control. In other words, each of the five components is relevant in all audits and is required to be understood, and that understanding of each component is required to be documented in every audit engagement.

AU-C 315A.A58 notes that the five components provide a useful framework for auditors when considering different aspects of internal control. AU-C 315A.A59 indicates that auditors may use different terminology or frameworks to describe various aspects of internal control, providing that the five components are addressed. As such, AU-C 315A recognizes that entities may design, implement, or maintain internal control using terms different from those five components, and AU-C 315A.A53 recognizes that the five components may not be clearly distinguished in smaller, less-complex entities. Those entities might not have extensive or formal descriptions of internal controls, descriptions of accounting procedures, or detailed policies.

Throughout this discussion, the authors refer to the internal control components of control environment, risk assessment, information and communication (excluding the financial reporting system), and monitoring as "entity-level" controls. These controls typically have a pervasive effect on the entity's system of internal control and can, therefore, potentially influence the design and operating effectiveness of other controls. The IT environment and general IT controls also have a pervasive effect and are considered at the entity level. The authors refer to the financial reporting system and the control activities component of internal control as "activity-level" controls.

COSO Internal Control Framework. Several internal control frameworks exist internationally, but the most widely used framework in the U.S. is COSO's *Internal Control—Integrated Framework* (the COSO framework), as revised in 2013. The five components of internal control listed above are the same five components that are defined and described in the COSO framework. The AICPA Risk Assessment Audit Guide references the COSO framework and related publications in various discussions of the auditor's understanding of internal control.

Smaller entities may not have formally adopted, or even be familiar with the COSO framework, but the authors believe that auditors turn to the COSO framework as a guide for understanding and evaluating internal control. The COSO framework helps entities design, implement, and evaluate internal control in light of the current operating and regulatory environments and operations by articulating 17 principles associated with the five components of internal control. Each principle has several underlying points of focus for evaluating the principle. COSO has also issued several related documents that provide tools, approaches, and examples to assist entities when designing, implementing, and assessing effectiveness of a system of internal control.

The AICPA Risk Assessment Audit Guide discusses various aspects of the COSO framework. For example, observations and suggestions are included, when relevant, with discussion of the 17 principles associated with the five components of internal control. Furthermore, Appendix C of that guide explains how the concepts in AU-C 315A correspond to the COSO framework and its 17 principles to help auditors relate the framework to the auditing standards. The audit guide also reminds auditors that while GAAS does not require the use of a specific framework, the COSO internal control framework is widely used by entities in connection with their internal control systems.

Uniform Guidance Requirements. In audits of nonprofit HUD entities, auditors need to consider that the Uniform Guidance (2 CFR section 200.303) states that the entity's internal controls over federal awards should be in compliance with guidance in *Standards for Internal Control in the Federal Government* (the "Green Book") or with the COSO framework. However, the GAS/SA Audit Guide, Paragraph 9.05, clarifies that there is no expectation or requirement for (a) an entity to document or evaluate internal controls prescriptively in accordance with the Green Book or the COSO framework or (b) the entity or its auditor to reconcile technical differences between them. Part 6 of the OMB Compliance Supplement addresses the objectives, principles, and components of internal control based on the Green Book and COSO framework.

Consideration of the COSO Framework in This Course. A detailed discussion of the COSO framework is beyond the scope of this course. However, the internal control practice aids in *PPC's Guide to HUD Audits* include the concepts from the COSO framework to assist auditors in obtaining an understanding and evaluating the design and implementation of internal controls. Given the widespread usage of COSO, reference is made to certain of the principles in the COSO framework. These principles are provided as considerations for the auditor when obtaining an understanding of the entity's internal control. The internal control practice aids in that *Guide* meet the requirements of AU-C 315A and have been updated to consider the principles in the COSO framework's principles.

Nature of the Auditor's Understanding

AU-C 315A.13–.14 requires auditors to obtain an understanding of internal control that is sufficient to assess the risk of material misstatement of the financial statements due to error or fraud and to design the nature, timing, and extent of further audit procedures. As noted in a nonauthoritative AICPA Technical Question and Answer, *Ineffective Controls* (Q&A 8200.11), auditors obtain a sufficient understanding of the five components of internal control to evaluate the design of controls and determine whether they have been implemented even if the auditor believes, prior to performing risk assessment procedures, that controls are nonexistent or ineffective. AICPA Technical Question and Answer, *Obtaining an Understanding of the Controls Relevant to the Audit* (Q&A 8200.19), also notes that the requirement to evaluate design and determine whether the controls have been implemented applies to each of the five components and is required every year. A key consideration is whether and how the entity's system of internal controls prevents, or detects and corrects, material misstatements in relevant assertions related to transactions, account balances, or disclosures, as well as misstatements caused by noncompliance.

Evaluation of design considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, material misstatements. In other words, the auditor considers the effectiveness of the control in achieving its objective. If a control is improperly designed, it may represent a control deficiency that needs to be communicated to management and those charged with governance, as more fully described in AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

The documentation of a control procedure, however, does not demonstrate that the control is actually being used. The auditor, therefore, also needs to determine if the control, as documented or described, actually exists and the entity is using it. In other words, an auditor uses risk assessment procedures to obtain audit evidence that the control has been implemented. Determining whether a control has been implemented confirms the auditor's understanding of control design and helps ensure that the risk assessment is based on complete and accurate information. Generally, the auditor uses procedures such as observation or inspection, combined with inquiries, to verify implementation. According to AU-C 315A.14, the auditor should evaluate the design of controls and determine whether they have been implemented by performing procedures in addition to inquiry. In other words, inquiry alone cannot provide a sufficient understanding of internal control.

Extent of the Auditor's Understanding

As previously indicated, the overriding criterion for the understanding of internal control is that it is sufficient to assess the risk of material misstatement of the entity's financial statements due to error or fraud, including misstatements caused by noncompliance, and to design the nature, timing, and extent of further audit procedures. Obtaining an understanding that is sufficient to assess the risks of material misstatement necessitates that the auditor develop a fairly thorough and robust knowledge of all five of the components of internal control. AU-C 315A.26–.27 indicates that to provide a basis for designing and performing audit procedures, the auditor should identify and assess the risks of material misstatement throughout the process of obtaining an understanding of the entity and its environment, including the relevant controls that relate to the risks. It is not necessary to obtain an understanding and evaluate all of the controls at the client. The use of the auditor's professional judgment is paramount in determining which controls are relevant to the audit and, thus, require an understanding and evaluation.

Generally, the extent of the auditor's understanding and the extent of the risk assessment procedures performed to obtain the understanding, are affected by factors such as the following:

- The auditor's prior experience with the client.
- Materiality.
- Size of the entity.
- Significance of the related risk.
- Nature of the client's business, including its organization and ownership characteristics.
- Diversity and complexity of operations.
- Nature and complexity of systems within the entity, including the use of third-party management companies and service organizations.
- Number of internal control systems in effect during the financial statement period.
- Nature of the multifamily housing industry.
- Applicable legal and regulatory requirements.
- The nature of compliance requirements and special reporting requirements.
- Level of business and financial sophistication of the client.
- The facts and circumstances relevant to the applicable control component.
- Whether and how a specific control, individually or in combination with other controls, prevents, or detects and corrects, material misstatements.

Understanding Controls Related to Significant Risks

AU-C 315A.30 indicates that the auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement that are considered significant risks. Fraud risks are always considered to be significant risks. Significant risks often relate to significant unusual transactions, for example, with related parties and judgmental matters such as estimates. Revenue recognition issues also often pose significant risks to auditors.

When considering the nature of the risks, a number of matters should be considered, including (a) whether the risk is related to fraud; (b) recent significant economic, accounting, or other developments; (c) the complexity of transactions; (d) whether it involves significant transactions with related parties; (e) the amount of subjectivity in the measurement of financial information related to the risk, especially measurements with a wide range of measurement uncertainty; and (f) whether the risk involves significant unusual transactions that are unusual or outside the normal course of business for the entity or that otherwise appear to be unusual. Significant risks are discussed further later in this section. According to AU-C 240.27, after completing risk assessment procedures to evaluate internal control design and implementation, the auditor determines whether a sufficient understanding has been obtained of controls that would prevent, or detect and correct, material misstatements related to fraud risks and other significant risks. If necessary, the auditor performs additional risk assessment procedures directed at gaining an understanding of controls relating to those risks.

Using the Results of the Understanding

As noted earlier, the understanding of internal control needs to be sufficient to assess the risks of material misstatement or noncompliance and to design the nature, timing, and extent of further audit procedures. Specifically, the understanding is used to:

- Identify types of potential material misstatements or noncompliance.
- Consider factors that affect the risks of material misstatement or noncompliance.
- Design tests of controls, when applicable, and substantive procedures.

In addition, the auditor remains alert for risks that may be identified during the process of obtaining an understanding of internal controls. The evaluation of the design and implementation of controls may identify previously unrecognized risks of material misstatement and result in modifying the preliminary assessment of inherent risk for a relevant assertion. Identified risks should be documented.

Considering Control Objectives/Principles and Key Controls

When obtaining an understanding of internal control, many auditors consider *control objectives* during the process of identifying controls and evaluating their design and implementation. A control objective states the purpose of a control (or controls) in relation to risks and "what could go wrong" in the financial statements. For example, "All property, plant, and equipment additions are correctly recorded," might be a control objective that addresses a risk of fixed asset transactions not being properly tracked and recorded (i.e., completeness). Failure to achieve that control objective could potentially result in overstatement or understatement of property and depreciation expense, as well as misstatements in other income statement accounts. Similar to control objectives, if a principle is not present and functioning at the entity, a risk could exist that misstatements or noncompliance could occur. For example, if the principle of "The entity demonstrates a commitment to integrity and ethical values," is not present and functioning, there is a risk that misstatements could occur throughout the financial statements primarily due to fraud.

The term *control objectives* in this course is commonly used in connection with controls relating to compliance with laws, regulations, and provisions of contracts and grant agreements. By considering control objectives (and principles) and how they relate to risks and what can go wrong at the relevant assertion level, an auditor might find it easier to identify existing controls and evaluate their design effectiveness. For example, an auditor might tailor inquiries of client personnel to focus on how certain control objectives are achieved within the entity when trying to identify the controls that address a particular risk of material misstatement or noncompliance. Likewise, when existing controls are identified, the auditor can evaluate whether those controls, if operating effectively, would fully achieve the objective or whether deficiencies exist because of improper design or missing controls. Common control objectives that relate to various audit areas and internal control components are presented throughout this section.

Key Controls. The auditor is not required to understand all controls and control activities that might exist in an entity. The auditor typically focuses attention on those controls that are most important in achieving particular control objectives (and principles). Often, an entity has multiple controls that contribute to achieving its control objectives related to identified risks. However, certain of those controls, referred to as *key controls*, are considered primary to achieving the objective. When identifying controls, evaluating design effectiveness, determining implementation, and, if applicable, testing controls, it is often more efficient and effective for the auditor to focus on *key controls*. Many times, these are the controls that the client believes are the most effective and reliable in operation to fully address a control objective. Often, especially for smaller entities, management review controls are key. When determining which controls are key, the auditor considers factors such as:

- The nature of the risks being addressed.
- The characteristics of related account balances, transaction classes, and disclosures.
- Whether the control is preventive (i.e., prevents misstatements) or detective (i.e., detects misstatements).
- Whether the control works in combination with or relies on the operation of other controls.
- Whether the control is manual or automated.
- Whether the control addresses more than one control objective.
- The nature and type of potential misstatements that the control would prevent, or detect and correct (i.e., would misstatements more likely arise from error, fraudulent financial reporting, or misappropriation of assets?).

Effect of Information Technology (IT) on Internal Control

IT systems may include packaged applications provided by vendors; custom developed applications; or end-user computing, such as spreadsheets, that provide accounting data used to generate financial reporting. Most HUD projects and management agents use IT to process accounting and other transactions. Applications are run using standard software that is designed for rental properties and has report features that provide printouts of the components of many asset and liability balances. Although many of the applications are integrated with the general ledger, some, such as the rent roll, may not. AU-C 315A indicates that auditors should consider how IT affects an entity's control activities. The effects can be extensive, but the effect on internal control is related more to the nature and complexity of the system than to the client's size. Information that may be useful in understanding the effect of IT on internal control includes understanding the role of IT in initiating, authorizing, recording, processing, and reporting transactions. While information systems may use off-the-shelf software or custom developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. How the client manages IT includes understanding the persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.

The GAS/SA Audit Guide, Paragraph 9.20, explains that it is especially important in a compliance audit for the auditor to obtain an understanding of how the entity has responded to risks arising from IT because the information systems and programs may include controls related to direct and material compliance requirements. The use of IT might affect any of the five components of internal control relevant to achieving financial reporting, operations, or compliance objectives, as well as the entity's operating units or business functions.

AU-C 315A.22 indicates that in understanding the entity's control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. Relevant controls not only include properly designed and implemented application controls, but the general controls upon which application controls depend. The AICPA Risk Assessment Audit Guide notes in Paragraph 4.63 that the auditor evaluates the design of IT general controls and determines whether they have been implemented when assessing the risks of material misstatement. Auditors test general controls when they plan to rely on IT application controls to modify the nature, timing, and extent of substantive procedures. The auditor also ought to be aware that the use of IT may impact the availability of information needed for the audit. Furthermore, in certain situations the auditor may be precluded from using only substantive procedures when the role of IT is significant to the processing of the transaction. For example, in highly automated processing with little or no manual intervention when information is initiated, authorized, recorded, processed, or reported electronically, the auditor may determine that detection risk cannot be adequately reduced without testing the operating effectiveness of controls. The understanding of the design and implementation of the entity's general IT controls should be documented.

Considering Whether Specialized IT Skills Are Needed to Understand Internal Control. Auditors need to consider whether specialized IT skills are necessary to determine the effect of IT on the audit, identify and assess IT risks, understand the IT controls, design and perform tests of IT controls or substantive procedures, or identify IT control deficiencies. That determination ought to be made relatively early in the planning process to ensure that the necessary resources are available on a timely basis. AU-C 300.A20 states that auditors may consider the following factors in determining whether the audit team needs to include individuals who possess specialized IT skills:

- Complexity of the entity's systems and IT controls and the manner they are used in conducting the entity's business.
- Significance of changes to existing systems or implementation of new systems.
- Extent to which systems share data.
- Extent of the entity's use of emerging technologies.
- Significance of audit evidence available in electronic form only.

An IT specialist may be either a member of the auditor's firm or an outside professional. When an IT specialist is used in the engagement, it may be advisable to include the specialist in the audit team discussions to help design relevant elements of the audit strategy and audit plan, including IT audit objectives, resource needs, and timing.

If the auditor uses an IT specialist on the engagement team, according to AU-C 300.12, the auditor should be knowledgeable enough to communicate the audit objectives to the specialist, evaluate whether the procedures performed by the specialist meet the auditor's objectives, and determine the results of the procedures on the nature, timing, and extent of other planned procedures. That does not mean auditors have to be experts in information technology. The AICPA Risk Assessment Audit Guide, at Paragraph 3.73, indicates that typically the auditor's responsibility when using an IT specialist is the same as for other members of the engagement team. To effectively supervise an IT specialist, auditors need a basic understanding of IT applications and controls, especially those most relevant to particular client systems. That understanding can be gained from experience with the client or from attending training classes or seminars. The extent of the understanding will vary with the nature of the entity's IT environment.

The authors believe there may be circumstances when the IT specialist will be considered an auditor's specialist rather than a member of the engagement team. In those cases, the auditor also needs to follow the requirements of AU-C 620A, *Using the Work of An Auditor's Specialist*. That guidance requires the auditor to evaluate the specialist's competence, capabilities, and objectivity; obtain a sufficient understanding of the specialist's field; reach agreement with the specialist about the work to be performed; and evaluate the adequacy of the specialist's work.

Government Auditing Standards Requirements. When specialists are used on HUD audits, the auditor has additional matters to consider. Those matters relate to technical knowledge and continuing professional education.

Cybersecurity. Cybersecurity risks have increased as entities have increasingly migrated to use of digital technologies in business and financial operations. Cybersecurity encompasses all IT-related controls in an entity's IT platform that guard against unauthorized access. *Cybersecurity risk* is the risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

General Effects of Cybersecurity Issues on the Audit. Cybersecurity risks and controls affect the audit of financial statements primarily with respect to the auditor's assessment of the risks of material misstatement of the financial statements, obtaining an understanding of IT controls and their effect on financial reporting, and assessing the effect on the financial statements of known cyber incidents. The auditor's concern about cybersecurity relates to data, systems that process that financial-statement-related data, and controls over those systems that could affect the financial statements and the safeguarding of assets in a material way. If certain control deficiencies are identified during the review of the entity's controls relevant to cybersecurity, the auditor should follow the requirements of AU-C 265, *Communicating Internal Control Related Matters Identified in an Audit*.

Inquiries of Management about Cybersecurity Risks and Controls. The auditors' inquiries of management need to include identification of the primary types of sensitive information the entity creates, uses, or stores that is susceptible to cybersecurity risk and management's process for dealing with these risks. Examples of inquiries that may be made include the following:

- The steps management has taken in designing and implementing controls at both the entity and activity levels to assess and respond to the risks.
- The steps management has taken to monitor the effectiveness of those controls.
- The internal process management has designed and implemented for identifying and communicating security events and/or security incidents.
- How management has responded to any security events and/or security incidents.

Engagement Team Discussion on Cybersecurity. In connection with the engagement team discussion, the engagement team needs to discuss the areas in the IT platform relevant to financial reporting that are vulnerable to cyber attacks or intrusion. The discussion could include the following matters:

- What are the primary types of sensitive information that the entity creates, uses, and stores?
- Are the control policies and procedures at both the entity and activity levels sufficient to safeguard the integrity of this data?
- How would a cyber attack affect the reliability of the entity's financial reporting or result in a material loss or impairment of the entity's assets?

Documentation

AU-C 315A.33 requires documentation of the understanding of the entity and its environment, including internal control. The auditor is required to document the understanding obtained for each of the five components of internal control. The auditor should also document the sources of the information used and risk assessment procedures that were performed to obtain the understanding.

In addition to obtaining an understanding of controls pertaining to financial statement assertions in a HUD engagement, an auditor also obtains an understanding of controls over HUD programs. The HUD audit guide, Paragraph 1-3(B), requires auditors of for-profit entities to obtain an understanding of controls pertinent to HUD programs. It states that "audit documentation should clearly demonstrate the auditor's understanding and assessment of control risk related to internal controls over compliance established for HUD-assisted activities."

For Single Audits of nonprofit HUD entities, the auditor considers the internal control components related to the applicable compliance requirements for each major program. The auditor can use the tests of internal controls performed as part of the compliance audit as a starting point when planning additional testwork for the financial statement audit. Even if the auditor would not test controls without the requirement to do so for compliance purposes, once those tests of controls are performed, the auditor ought to take advantage of the testwork results when planning and performing the financial statement audit.

Control Environment

What Is the Control Environment? The control environment sets the tone of an entity and influences the control consciousness of its people. The control environment is the foundation for all other components of internal control and provides structure and discipline. Among the important elements of the control environment are the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control.

The elements of the control environment that may be relevant when understanding the control environment include:

- Communication and enforcement of integrity and ethical values.
- Commitment to competence.
- Attention and direction provided by owners, a board of directors or audit committee.

- Participation of those charged with governance.
- Management's philosophy and operating style.
- Organizational structure.
- Assignment of authority and responsibility.
- Human resource policies and procedures.

An entity's control environment is a significant factor when considering the risks of material misstatement due to error or fraud. The integrity of the project owner and management agent (if applicable) or top managers will often play a significant role in establishing a strong control environment. Accordingly, AU-C 315A.15 requires the auditor, when obtaining an understanding of the control environment, to evaluate whether management and those charged with governance have created and maintained a culture of honesty and ethical behavior. For example, although an entity might not have a written code of conduct, it might still have a culture that emphasizes the importance of integrity and ethical behavior. That culture will be instilled through the visibility and direct involvement of the project owner or top management. Obtaining an understanding of the control environment of a HUD-assisted project need not be a complex process. The control environment is simply the conditions and circumstances that exist within the entity that demonstrate management's attitude about controls and other indicators of management's integrity and motivation.

The auditor generally obtains a sufficient knowledge of the control environment as a result of performing risk assessment procedures to understand the attitudes, awareness, and actions of management and those charged with governance concerning internal control and its importance in achieving reliable financial reporting. The auditor should evaluate whether the control environment elements collectively provide support for the other components of internal control and whether those other components are undermined by deficiencies in the control environment. The responsibilities assumed by management and those charged with governance related to financial reporting are particularly important. For example, the auditor might identify the members of management, and directors if any, who are expected to understand the HUD project's business transactions and to evaluate whether they are appropriately reflected in the financial statements. The auditor considers both (a) the aspects of the control environment that help insure the integrity of financial reporting (that is, the key control environment controls) and (b) any control environment weaknesses that could have a pervasive effect on the financial statements.

The following COSO principles incorporate the control environment elements discussed above:

- The entity demonstrates a commitment to integrity and ethical values.
- The board of directors/those charged with governance demonstrate independence from management in exercising oversight of the development and performance of internal control over financial reporting.
- With oversight from the board of directors/those charged with governance, management establishes structures, reporting lines, and appropriate authorities and responsibilities to achieve financial reporting objectives.
- The entity demonstrates a commitment to attract, develop, and retain competent individuals in alignment with financial reporting objectives.
- The entity holds individuals accountable for their internal control responsibilities.

Risk Assessment Procedures and Factors to Consider. Audit evidence related to elements of the control environment may be obtained through a combination of inquiries and other risk assessment procedures. Auditing standards place an emphasis on corroborating management's and employees' responses to inquiries through observation or inspection. For example, through inquiries of management and employees, the auditor obtains an understanding of management's commitment to ethical values and competence. The auditor follows through with observation of the behavior and attitude demonstrated by management in managing the business.

The audit evidence for the control environment is often not available in documentary form. When it is available, the auditor may inspect documents, for example, a written code of conduct, as evidence of how management communicates its views of business practices and ethical behavior. While formal documentation may be preferable, it is not always necessary for a policy to be in place and operating effectively. For example, in a small HUD project, all of the human resource policies may not be formally documented as they would in a larger entity. Even so, policies and practices can still exist and be communicated orally. When documentary evidence is not available, the auditor might observe management's and directors' actions and attitudes. When the client's documentation is minimal, the auditor may need to provide more robust documentation of his or her understanding of the control environment to serve as a basis for determining the nature, timing, and extent of further audit procedures.

In performing risk assessment procedures, an auditor needs to reconsider the background information on the project owner's integrity along with the knowledge that has been obtained about the client's operations and environment. The purpose of the auditor's reconsideration is to assess whether the attitude of the project owner or management in the particular circumstances might create an increased risk of material misstatement of the financial statements. A project owner, because of the ability to dominate activities or override controls, is in a position to execute and conceal improper transactions. Even a basically honest project owner may be motivated in some cases to materially misstate the financial statements, and an auditor needs to recognize these circumstances and consider them in planning, especially when identifying risks of material misstatement of the financial statements due to fraud.

Documentation of the Control Environment. The auditor's understanding of the entity's control environment, along with the sources of information and procedures performed to obtain or update the understanding, should be documented. It is a best practice to provide an overall conclusion regarding whether the control environment is properly designed and implemented considering the overall size and complexity of the entity.

Risk Assessment

Risk assessment is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives. With respect to the objective of reliable financial reporting, the entity's risk assessment process involves the identification, analysis, and management of the risks of material misstatement of the financial statements. An entity's risk assessment process includes the following:

- Financial reporting objectives.
- Management of financial reporting risks.
- Consideration of fraud risk.
- Consideration of changes that could impact internal control.

AU-C 315A.17–.18 require the auditor to obtain an understanding of the entity's risk assessment process and the results of that process. If the auditor identifies risks of material misstatement or material noncompliance that the entity did not identify, the auditor should evaluate whether the entity's risk assessment process failed and, if so, why it failed and whether the process is appropriate in the circumstances or contains a significant deficiency or material weakness. If the entity does not have a formal risk assessment process, the auditor should discuss with management whether risks relevant to financial reporting have been identified and how they were addressed. The auditor should also evaluate whether the lack of a documented process is appropriate for the entity or represents an internal control deficiency that needs to be evaluated to determine whether it is a significant deficiency or material weakness.

The auditor generally obtains sufficient knowledge of management's risk assessment process as a result of applying risk assessment procedures to understand how management considers and decides about actions to address risks relevant to reliable financial reporting and compliance objectives and decides about actions to address those risks. In some cases there will be a formal risk assessment process, but a formal process is not essential. The auditor should obtain an understanding of the following issues:

a. How does management identify risks relevant to financial reporting and to compliance?

b. How does management estimate the significance of the risks?

c. How does management assess the likelihood of their occurrence?

d. How does management decide on actions to manage the risks?

The auditor concentrates on the effectiveness of management's efforts to identify and deal with the risks of material misstatements or material noncompliance. The auditor considers both (a) the aspects of the entity's risk assessment process that enable management to identify, analyze, and address risks and (b) any difficulties in identifying and addressing those risks.

The Entity's Fraud Risk Assessment and Monitoring. All entities ought to be proactive in reducing fraud opportunities by identifying and measuring fraud risks, taking steps to mitigate identified risks, and implementing and monitoring appropriate preventive and detective controls and other antifraud measures. However, the nature and extent of these risk assessment and monitoring activities need to be commensurate with the size and complexity of the entity. The fraud risk assessment and monitoring process for a typical small to midsize HUD project may include:

a. Communicating to employees the project owner's views on business practices and ethical behavior, either orally or by example.

b. Thoroughly investigating any incidents of alleged fraud, taking appropriate and consistent actions against violators, assessing how relevant controls could be improved, correcting any effects on the financial statements, and reinforcing the entity's values and expectations through appropriate communication.

c. Considering standards of ethical behavior and appropriate business practices in the entity's employee training and evaluation procedures.

d. Identifying and assessing fraud risks and taking appropriate action to reduce or eliminate the risks.

e. Exercising appropriate oversight of the entity's fraud risk assessment and monitoring activities by the board of directors or audit committee.

Risk Assessment Procedures and Factors to Consider. The auditor should gain an understanding of how the HUD project's management identifies and takes action to address risks relevant to the project's financial reporting objectives. This includes gaining an understanding of how management estimates the significance of those risks and assesses the likelihood of their occurrence. For risks related to fraud, the auditor should gain an understanding of whether the entity has assessed its vulnerabilities to fraudulent activity (including determining whether those exposures could result in material misstatement of the financial statements or material noncompliance with provisions of laws, regulations, contracts, and grant agreements) and whether the entity has identified and implemented the processes, controls, and other procedures needed to mitigate identified fraud risks. Gaining an understanding of management's risk assessment is not a complex process. Normally, the auditor can gain this understanding based on his or her experience with the entity, general observations of its operations, and discussions with management.

Documentation of the Client's Risk Assessment Process. The auditor's understanding of the entity's risk assessment process, along with the sources of information and procedures performed to obtain or update the understanding, should be documented.

Information and Communication

Information refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, record, process, and report the HUD projects transactions. It also includes the accountability over the assets, liabilities, and equity. An information system may be automated, manual, or a combination of the two depending on the size and complexity of the entity. *Communication* is the process of providing an understanding of roles and responsibilities to individuals within the entity regarding internal control over financial reporting. Although part of the same internal control component, the authors discuss the financial reporting system and communication process separately in the following paragraphs.

Information System. *Information system* refers to the financial reporting system. AU-C 315A.19 states that the auditor should obtain sufficient knowledge of the financial reporting system, including related business processes, to understand the following:

a. *Classes of Transactions.* The classes of transactions in the entity's operations that are significant to financial reporting.

b. *Accounting Procedures.* The procedures, within both automated and manual systems, by which those transactions are initiated, authorized, recorded, processed, corrected as necessary, transferred to the general ledger, and reported in the financial statements.

c. *Accounting Records.* The related accounting records, whether electronic or manual, supporting information, and specific accounts in the financial statements involved in initiating, authorizing, recording, processing, and reporting transactions.

d. *Other Events and Conditions.* The methods used to capture events and conditions, other than classes of transactions, that are significant to the financial statements. Examples include asset impairment, commitments and contingencies, concentrations, subsequent events, compliance with debt covenants, related-party transactions, going concern uncertainties, and fair values of financial instruments.

e. *Financial Reporting Process.* The financial reporting process (including the closing process) used to prepare the entity's financial statements, including significant accounting estimates and disclosures.

f. *Journal Entries.* The controls over standard and nonstandard journal entries.

This understanding of the information system relevant to financial reporting should include relevant aspects of that system relating to information disclosed in the financial statements that is obtained from within or outside the general or subsidiary ledgers.

The auditor's understanding is at a high level but sufficiently detailed to identify the significant accounting applications, how the computer is used in those applications, and the relative complexity and importance of use of the computer. The auditor also considers the qualifications of accounting personnel and the time pressure they face. Inexperienced or harried accounting personnel make more errors.

Auditors need to be satisfied that they have a sufficient understanding of the entity's financial reporting system to understand how material misstatements might occur anywhere in the cycle from the occurrence of transactions to the final presentation of the project's financial position and results of operations in the financial statements. Also, as required by AU-C 315A.22, when understanding control activities, the auditor should obtain an understanding of how the entity has responded to risks arising from IT. This typically means that when obtaining an understanding of the financial reporting system, the auditor obtains knowledge of relevant IT application controls. Application controls apply to a specific application, such as accounts payable, payroll, or the general accounting application. They apply to the processing of individual transactions and help ensure that the transactions occurred, are authorized, and are completely and accurately recorded and processed.

In a simple financial reporting system, the authors believe understanding the financial reporting system will generally involve:

- Understanding the financial close and reporting process.
- Identifying the entity's significant transaction classes.
- Understanding the flow of information through the financial reporting system for significant transaction classes.

<u>Understanding the Financial Close and Reporting Process.</u> Events and conditions other than transaction classes (that is, other than items processed through the entity's transaction processing systems) are often material to the preparation of financial statements. Examples include accruals for contingencies, commitments, and related party transactions. It is not enough for the auditor to understand the flow of transactions through the financial reporting system for significant transaction classes. The auditor also needs to understand how information about other significant events and conditions is captured. Therefore, for any accounts where material amounts enter the general ledger from sources other than the entity's transaction processing systems, the auditor needs to understand how information about those events and conditions is captured for inclusion in the general ledger and financial statements. Also, for audit areas that require significant disclosure information that is not available from the entity's general ledger or related supporting documents and records, the auditor needs an understanding of how information for disclosures is captured for inclusion in the financial statements. The financial close and reporting process is

particularly important to achieving reliable financial reporting. Weaknesses in the financial reporting process can create risks of material misstatement.

Identifying Significant Transaction Classes. The auditor identifies significant classes of transactions and obtains an understanding of the flow of information (including electronic information) through the entity's financial reporting system for each of these classes. Significant transaction classes are those classes of transactions in the entity's operations that are significant to the financial statements, generally because of the volume or risk characteristics of transactions processed.

Transactions classes that are significant to HUD-assisted entities include the following:

- Rental revenues.
- Revenues for rent subsidies and the related receivable.
- Deposits and withdrawals of residual receipts and surplus cash.
- Collection and refunds of security deposits.
- Expenditures from the replacement reserve account.
- For Section 236 projects, amounts due to HUD.

Risk Assessment Procedures. Risk assessment procedures that are ordinarily performed to understand the financial reporting system include inquiries of the HUD project's management and others, observation of procedures and controls, inspection of documents and records, and tracing transactions through the system (i.e., walkthroughs). As with the other areas of understanding the entity and its environment, the nature and extent of the procedures performed are affected by factors such as the size of the entity, its complexity, and most certainly, the number of significant transaction classes that exist within the entity.

The existence of any internal documentation that describes classes of transactions and the transaction flow in the accounting system is a key factor that may influence the risk assessment procedures used when obtaining an understanding of the financial reporting system. Typically, such documentation exists for larger and more complex entities, such as large property management companies, and may consist of the following:

- Training manuals for employees.
- Policy and procedure manuals.
- Formal memoranda and flowcharts.
- Internal audit analyses.

When such documentation exists, the auditor's risk assessment procedures typically include inspection and review of this documentation, corroborated by inquires of various personnel to determine if the information is current, and observation and walkthroughs to verify that procedures are being followed. While the client's internal control documentation is an excellent source for understanding and evaluating the design of the financial reporting system, risk assessment procedures consisting of inquiry, observation, and inspection are necessary to ensure that the system has been implemented as designed.

However, for many HUD projects, the range of control and day-to-day involvement of the owner and management frequently make written documentation of the processing systems unnecessary. For those HUD projects, the auditor often relies on inquiries of the owner, management, and accounting personnel to understand the design of the financial reporting system. The auditor determines that the system as described has been implemented by performing observation and inspection procedures, such as walkthroughs.

Walkthroughs. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is to trace a transaction through the various processing steps and related controls from initiation to inclusion in the general ledger and financial statements. This is commonly referred to as a "walkthrough" procedure. Walkthroughs may be used to confirm information obtained by inquiry or from prior years' audits. Walkthroughs are also commonly used in gaining an understanding of related control activities. Paragraph 3.123 of the AICPA Risk Assessment Audit Guide and Paragraph 3.25 of the AICPA Audit Guide, *Audit Sampling*, note that a walkthrough may be designed to include procedures that are also tests of the operating effectiveness of controls.

Walkthroughs of transactions include document inspection and inquiry and observation. The auditor judgmentally selects one or a few transactions from each of the major classes of transactions and walks those transactions through the system from initial creation of a source document to final posting in the general ledger and inclusion in the financial statements. The auditor inspects the documents and accounting records used in processing, talks to the personnel involved, and observes the handling of records and related assets.

Communication. Communication relates to providing a clear understanding of internal control over financial reporting and over compliance, how they work, and the roles and responsibilities of individuals within the entity related to internal control. The communication process includes both internal and external elements. For example, it includes communications between the project's owner, management employees, those charged with governance, and regulatory authorities. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. This will depend on the size and organizational structure of the entity. The auditor should obtain a sufficient understanding of how management communicates financial reporting and compliance roles and responsibilities and other significant matters. Auditors consider both:

- The aspects of the communication process that help to ensure employees and those charged with governance understand their jobs and responsibilities and are encouraged to report any exceptions.
- Any areas where communication does not occur.

Communication is another way that management conveys the tone at the top. The project owner and management ought to communicate the information necessary for employees to perform their assigned tasks, for managers to supervise, and for responsible parties to make key operating and financial decisions. Communication also relates to the flow of information upstream in an entity. For upstream communication to occur, there needs to be open channels of communication and a willingness on the part of management to deal with problems. For control activities to be effective, individuals need to be able to report exceptions or fraud to the appropriate levels of management.

When considering whether a HUD entity has communication controls in place, auditors consider whether management has clearly communicated the following:

- That internal control responsibilities are a critical part of employee job duties.
- The role and responsibilities that each employee has in the internal control system.
- That unexpected events are to be investigated, including determining the cause of the event.
- How job activities relate to the work of others.
- That communication from employees to management concerning exceptions, problems, controls, potential fraud, or other issues is both welcomed and expected.
- That, if an employee feels that taking an issue through the normal upstream communication methods would not be effective, alternative channels of communication are available (such as a direct communication to senior management).

<u>Risk Assessment Procedures and Factors to Consider.</u> Communication may be written, electronic, oral, or through the direct actions and involvement of management. As a result, auditors often use a combination of risk assessment procedures to understand the communication process. In addition to inquiries of management, the auditor may consider the following types of procedures to corroborate management's responses and determine if the communication process as designed has been implemented:

- Inquire of employees regarding the communication that they have received regarding their duties and management's expectations as they relate to financial reporting and compliance.

- Review policy and procedures manuals or similar documents that have been provided to employees regarding their duties.
- Review for the existence of training materials or programs on job functions and responsibilities.
- Discuss with human resources personnel the evaluation process and how job knowledge and the performance of responsibilities are incorporated into personnel reviews.
- Inquire of the audit committee and review minutes of meetings (or summaries of recent meetings for which minutes have not yet been prepared) regarding the communication between management and those charged with governance.
- Inquire of employees regarding how upstream financial communication is received and implemented by management.
- Review whistleblower policies and inspect documentation regarding reported instances of suspected financial improprieties.
- Inquire and review related documentation about how communication from external parties is processed.

Documentation of the Understanding of Information and Communication. The auditor's understanding of the entity-level information and communication processes, along with the sources of information and procedures performed to obtain or update the understanding, should be documented.

Documenting the Financial Reporting System and Walkthroughs. As discussed earlier in this section, the understanding of the information component includes a sufficient knowledge of the financial reporting system for significant transaction classes, including the financial close and reporting process. This understanding should be documented. When obtaining an understanding of the financial reporting system, the auditor will generally obtain knowledge of various control activities that relate to the processing of transactions and the financial close and reporting process. Knowledge obtained about these activities should also be documented. Control activities are discussed further later in this section.

The auditor's walkthrough procedures for each significant transaction class, as well as information about the financial reporting system, should also be documented.

Monitoring

Monitoring is a process by which an entity assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud. Effective monitoring ensures that internal controls are modified as changes in conditions occur in the entity. As a result, poor monitoring controls can allow error or fraud to remain undetected. The elements of an entity's monitoring process include (a) ongoing and/or separate evaluations and (b) evaluation and reporting of internal control deficiencies.

Monitoring can be accomplished through ongoing activities, separate evaluations, or a combination of the two. Ongoing monitoring includes management and supervisory activities and other actions that personnel take in performing their duties, such as performing comparisons, reconciliations, and other routine activities. For example in a HUD project, the project owner or manager may question reports that differ significantly from his or her knowledge of operations. Because these activities are performed in the normal course of business, ongoing monitoring procedures usually adapt to changing conditions and may be timely in detecting problems. Separate evaluations may involve any aspect of the entity's system of internal control such as management's review of a component (e.g., the control environment), an element within a component, or the control activities associated with a specific class of transactions or processing function. Regardless of the manner in which monitoring is accomplished, identified deficiencies ought to be reported to the individuals responsible for taking corrective action and to management and those charged with governance, as appropriate.

According to AU-C 315A.23, the auditor should obtain an understanding of the major types of activities that management uses to monitor internal control over financial reporting, including control activities relevant to the audit. AU-C 315A.25 further indicates that the auditor's understanding should include the sources of information related to monitoring and the basis on which management considers information to be sufficiently reliable for that purpose. The auditor considers both (a) the aspects of the monitoring process that enable management to appropriately identify and correct control procedures that are not operating as intended and (b) any circumstances that indicate management has failed to appropriately identify and correct such deficiencies.

Monitoring can be virtually any activity that ensures that controls are operating as intended and continue to be properly designed. Monitoring may include activities such as the following:

- Review of whether bank reconciliations are prepared on a timely basis.
- Review of tenant complaints regarding the billing process.
- Review of a reporting system that tracks timely collection efforts.
- Analysis of reported disbursement errors.
- Legal department review of compliance with ethics policies.
- Separate evaluation by internal audit regarding revenue recognition.

For audits of HUD-assisted projects, the auditor may not have to spend a great deal of time gaining an understanding of the client's monitoring process. Normally, the auditor can gain this understanding based on his or her experience with the client, general observations of project operations, and discussions with the owner and management.

Documentation of the Client's Monitoring Process. The auditor's understanding of the entity's monitoring process, along with the sources of information and procedures performed to obtain or update the understanding, should be documented.

IT Environment and General IT Controls

IT Environment. Use of the Internet or any other information technology does not necessarily mean that an entity's internal control is heavily dependent on IT. For example, an entity with a simple IT system may use primarily paper-based manual procedures to enter lease details, prepare invoices, and maintain accounts payable. The client may also use manual controls, such as approvals, reconciliations, reviews, and follow-up of exceptions. In a system that uses automated procedures to initiate, record, process, and report transactions, electronic records replace many of the paper forms. Controls in that environment generally consist of a combination of automated and manual controls. Automated controls include processes such as edit and validation routines embedded in software. In addition, the nature of the manual controls may be different. Manual controls in an automated system may be independent of the IT system, may use information produced by the system, or may be limited to monitoring the automated controls and handling exceptions. The mix of manual and automated controls varies with the nature and complexity of the client's system.

The auditor should document the understanding of the extent to which IT is used in significant transaction classes, and whether the use of an IT specialist is considered necessary, as well as concluding on the proper design and implementation of general IT controls.

Control Activities

Control activities are the policies and procedures that help ensure that management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting. Control activities usually involve two elements: (a) a policy that establishes what ought to be done and (b) the procedure that implements the policy. AU-C 315A.21 requires the auditor to obtain an understanding of control activities relevant to the audit and explains that they are those that "the auditor judges it necessary to understand in order to assess the risks of material misstatement at the assertion level and design further audit procedures responsive to the assessed risks."

AU-C 315A.A166 provides examples of categories of control activities that are relevant to the audit are as follows:

- *Performance Reviews.* Comparisons of current financial reports to other information.
- *Information Processing.* Control activities that are performed to check accuracy, completeness, and authorization of transactions. For information processing systems, there are two broad categories of control activities—application controls and general controls.
- *Physical Controls.* Controls that pertain to the physical security of assets including adequate safeguards that limit access to assets; authorization to access software, including coding and files; and periodic counting and comparison to control records.
- *Segregation of Duties.* The assignment of different people to authorize transactions, record transactions, and maintain custody of assets.
- *Accountability.* Controls relating to reconciliations of the detailed records to the general ledger.

The *primary* control activities of interest to auditors of HUD-assisted projects are those concerning leasing activities and disbursements. Often the auditor's knowledge of those activities is obtained simultaneously with obtaining an understanding of the other internal control components.

AICPA Nonauthoritative Guidance on Control Activities Relevant to the Audit. The AICPA has issued Technical Questions and Answers that provide nonauthoritative guidance on those control activities that are always relevant to the audit and those that may be relevant to the audit based on auditors' evaluation of all the particular facts and circumstances of the engagement.

<u>Control Activities Always Relevant to the Audit.</u> The AICPA Technical Question and Answer, *Control Activities Always Relevant to the Audit* (Q&A 8200.20), indicates that certain control activities, if present, are always relevant to the audit. It states that these control activities are those that address the following matters:

- Significant risks.
- Fraud risks.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.
- Risks for which there is an intention to rely on operating effectiveness of controls to determine the nature, timing, and extent of substantive procedures.
- Recording of journal entries including nonstandard entries that record adjustments or nonrecurring, unusual transactions.
- Responses by the entity to risks arising from IT that may affect the design or implementation of control activities.
- Use of service organizations that fall into any of the above categories.

<u>Control Activities That May Be Relevant to the Audit.</u> AICPA Technical Question and Answer, *Control Activities That May Be Relevant to the Audit* (Q&A 8200.21), observes that auditors need not obtain an understanding of all control activities related to each significant class of transactions, account balance, or disclosure in financial statements or to every assertion that is relevant to them. It notes that the following factors may be helpful in identifying whether control activities other than those listed in the previous paragraph are relevant to the audit:

- Analysis of risks of material misstatement to identify control activities related to higher risks of material misstatement.
- Consideration of whether the understanding of other components of internal control indicates a need for additional attention to particular control activities.
- Analysis of deficiencies related to general IT controls or implementation of new systems to identify the effect on the effectiveness of the design or operation of application controls.

- Identification of lack of segregation of duties that limits the importance of control activities and may increase that of other controls such as management review controls.
- Identification of legal or regulatory requirements that increase the importance of particular control activities.
- Decisions to use information produced by the entity in designing and performing further procedures that increase the importance of controls over the completeness and accuracy of that information.
- Determination that control activities related to nonfinancial reporting objectives of internal control, such as operations or compliance, are relevant to the reliability of financial reporting.
- Determination that control activities that are always relevant to the audit are dependent on other control activities.

Obtaining an Understanding of Control Activities. The auditor first considers knowledge about control activities obtained through the understanding of other components of internal control before investing additional efforts. Generally, the auditor accumulates a significant amount of knowledge about control activities through the process of obtaining an understanding of the other components of internal control.

The auditor may also learn of control activities while performing risk assessment procedures to obtain the understanding of the entity and its environment discussed earlier in this lesson. Most frequently, however, the auditor learns of control activities while obtaining an understanding of the financial reporting system. A natural by-product of the understanding of how transactions are initiated, authorized, processed, corrected, transferred to the general ledger, and recorded is knowledge of how control activities ensure that relevant assertions are achieved.

<u>When Is an Additional Understanding of Control Activities Necessary?</u> The auditing standards do not require an understanding of all of the control activities related to each class of transactions, account balance, and disclosure in the financial statements or to every assertion. (However, professional standards do require the auditor to obtain an understanding of the process of reconciling detail to the general ledger for material accounts.) The auditor's emphasis is on understanding control activities that allow the assessment of risks of *material* misstatement at the *relevant* assertion level and to design and perform further audit procedures that are responsive to those risks. Thus, after considering the control activities previously identified, the auditor evaluates whether a sufficient understanding of control activities has been obtained for those areas where the auditor considers material misstatements more likely to occur. The auditor's evaluation will be focused on significant transaction classes and accounts. Auditors should consider that information relating to financial statement disclosures may be obtained from within or outside of the entity's general and subsidiary ledgers, and use professional judgment in determining the necessary understanding of relevant aspects of the information system(s) involved. The auditor may need to devote additional attention to obtaining an understanding of control activities in certain circumstances. For example, it is necessary to obtain an additional understanding if:

- The auditor does not understand what controls, if any, the entity has implemented to prevent, or detect and correct, material misstatements in specific assertions related to fraud risks or other significant risks.
- The auditor plans or is required to test controls for one or more assertions but has not identified which controls to test (that is, which manual or automated controls are most likely to prevent, or detect and correct, material misstatements in that assertion.)

Even if the auditor concludes additional attention to control activities is necessary, the auditor can focus on controls related to selected transaction classes, account balances or disclosures at the assertion level. The practical implication of this selective approach is that it is not necessary to complete an internal control questionnaire or prepare additional documentation to describe the control activities for all material account balances, transaction classes, or disclosures. The auditor may identify key balances, classes, or assertions and conclude that a further understanding of control activities is necessary only for those selected areas.

Documentation of Control Activities. Control activities should be documented, including describing the sources of information used and the procedures performed, as well as concluding whether the controls over the significant transaction classes in the audit area are properly designed and implemented.

Understanding Controls Related to Significant Risks

AU-C 315A.30 indicates that the auditor's understanding of internal control should include the entity's programs and controls that address risks of material misstatement that are considered significant risks. When considering the nature of the risks, a number of matters should be considered, including whether the risk (a) relates to recent significant economic, accounting, or other developments; (b) involves significant transactions with related parties; (c) involves significant unusual transactions that are unusual or outside the normal course of business for the entity or that otherwise appear to be unusual; or (d) is a risk of fraud. The auditor also should consider the degree of subjectivity in the measurement of financial information and the complexity of the transactions.

Fraud risks are always considered to be significant risks. Significant risks often relate to significant unusual transactions, for example, with related parties and judgmental matters, such as estimates. Revenue recognition issues also often pose significant risks to auditors. Programs and controls addressing fraud risks or other significant risks may relate to any of the five components of internal control; thus, auditors need to use care not to isolate the understanding to only the control activities component. The auditor ought to be alert to the fact that fraud risks or other significant risks may not be subject to routine controls given the nature of the risk. Also, the auditor's understanding extends to whether and how management responds to those risks.

Controls that address fraud risks frequently relate to the following:

a. *Control Environment.* Fraud programs designed to prevent, deter, and detect fraud. For example, programs to promote a culture of honesty and ethical behavior.

b. *Control Activities.* Specific controls designed to mitigate specific risks of fraud. For example, controls to address specific assets susceptible to misappropriation.

As with other controls, the auditor evaluates whether the programs and controls that relate to significant risks are suitably designed and implemented and assesses the risks of material misstatement due to error or fraud in light of this evaluation. The existence (or lack) of these programs and controls might either mitigate or increase the risks of material misstatement. The auditor considers control activities that are relevant to account balances with a significant inherent risk of misappropriation of assets. The risk of misstatement due to fraud for misappropriation of assets always depends on whether there are controls to prevent or detect concealment of theft in the accounting records.

Test of Controls

If the auditor devotes additional attention to control activities because his or her assessment of control risk includes an expectation that the controls are operating effectively, (which would permit modification of substantive procedures), the auditor will need to perform tests of controls. *PPC's Guide to HUD Audits* includes practice aids to facilitate documentation of the performance of tests of controls and the results of those tests.

Internal Controls, Service Organizations, Management Agents, and Audit Strategy

There is a tendency to think of the auditor's responsibilities related to a client's use of a service organization as limited to situations such as use of an outside data processing center, or circumstances in which it is known that a report on controls at a service organization is available. That is not the case. AU-C 402 is applicable when the services provided are relevant to the audit because those services, and the controls over them, affect the HUD project's information system and related business processes relevant to financial reporting, including controls over safeguarding of assets. AU-C 402 does not apply to a service organization's services that are not a part of the HUD project's information system and related business processes relevant to financial reporting. In the authors' experience, owners of HUD-assisted entities often employ property management companies and payroll service companies that meet the definition of a service organization at AU-C 402.08 because of the relevance of their services to the entity's internal control over financial reporting.

The auditor should determine the significance of service organization processing to the client's internal control over financial reporting. Typically, in making a determination of whether service organization processing is significant to the client, the auditor considers the interaction of the client's controls (user controls) with the service organization, the nature of the services provided, and the nature and materiality of transactions processed by the service organization. The degree of interaction between the activities of the service organization and those of the user entity refers to whether the client is able to implement effective controls over transactions processed by the service organization.

When a HUD-assisted entity outsources a significant activity or business process, the auditor needs to evaluate the effect on internal control over financial reporting. AU-C 402 emphasizes the importance of obtaining an understanding of how the entity uses the services of a service organization and how those services and the activities of the service organization affect the risks of material misstatement. The procedures to obtain that understanding include specifically reading the relevant contractual terms. For example, does the agreement with the property management company limit the company's authority when executing repairs contracts or equipment leases? The auditing requirements emphasize obtaining a broad and deep understanding of the role of the service organization in the user entity's financial reporting system and making a rigorous assessment of information about the service organization. (This would include a probing analysis of a service auditor's report if one is used by the auditor.)

A property management company employed by an owner of a HUD-assisted project may be a "fee for services" company (that is, not a related party), but in many cases, the owner will have an ownership interest in the property management company. The property management company will usually have broad responsibilities to—

- Maintain the accounting records for the HUD-assisted property, including billing and collecting rent and processing and paying accounts payable.
- Pay debt service.
- Comply with HUD requirements in the regulatory agreement and other applicable laws and regulations.
- Execute certain contracts on behalf of the owner.
- Hire, train, and supervise employees (usually employees of the property management company whose cost is "charged back" to the property).
- Interface with the audit team.

Because the property management's responsibilities are significant to the HUD-assisted entity's internal control over financial reporting, AU-C 402 needs to be viewed together with, rather than separate from, the basic requirements for consideration of controls that are prescribed by AU-C 315A and discussed previously in this section. For example, AU-C 402 does not change the basic requirement of AU-C 315A to obtain an understanding of controls sufficient to assess the risk of material misstatement of the financial statements and enable the auditor to—

a. design tests of controls, when applicable, and
b. design substantive procedures.

Thus, when the auditor in a HUD audit engagement obtains an understanding of internal control at the property management company, the auditor should evaluate the design and implementation of relevant controls that relate to the services provided by the property manager, including controls applied to the transactions it processes.

AU-C 402.11 requires the auditor to ensure that he or she has obtained a sufficient understanding or test of the nature and significance of services provided by a service organization and their effect on the client's internal control to provide a basis for identifying and assessing risks of material misstatement. In some cases, the understanding obtained at the user entity may be sufficient for that purpose. That is, depending on the facts and circumstances, the auditor may not need to obtain an understanding or test the service organization's controls in order to assess risk and plan and perform the audit. That may be, for example, because the client has effective user controls and the services provided by the service organization are generally limited to processing and recording the transactions, as contrasted to transaction initiation and authorization. In other situations, the nature of the services being provided by the service organization does not affect the client's information system. However, the auditor needs to carefully consider the nature of the services to determine if there could be a potential impact on the financial statements.

In some cases, the auditor may be unable to obtain a sufficient understanding of the nature and significance of the service organization's services and their impact on the client's internal control to identify and assess the risks of material misstatement based only on information at the user entity. This might be the case if the owner of the HUD-assisted entity, or the property management company, employs a payroll service company.

If the auditor is unable to obtain a sufficient understanding from the user entity, the auditor is required to obtain the necessary understanding by performing one or more of the following procedures:

a. Obtain and read a type 1 or type 2 report.

b. Obtain specific information by contacting the service organization through the user entity.

c. Visit the service organization and perform procedures to obtain the necessary information about relevant controls.

d. Use another auditor to perform procedures to obtain the necessary information.

An in-depth discussion of using service auditor's reports is beyond the scope of this course. *PPC's Guide to Audits of Nonpublic Companies* provides guidance on the use of service organizations.

Understanding Internal Control over Compliance

When performing a HUD audit, the auditor is not only concerned with obtaining an understanding of internal control over the financial statements as a whole as required by GAAS and the Yellow Book. Paragraph 1-3(B) of the HUD audit guide states the auditor has additional responsibilities:

> When auditing HUD programs, the auditor should perform tests of controls to evaluate the effectiveness of the design and operation of internal controls in preventing or detecting material noncompliance with the direct and material requirements of the major HUD-assisted programs. The auditor should perform these procedures regardless of whether the auditor assesses the internal control risk to be below the maximum. The steps performed and conclusions reached should be clearly stated in the audit documentation. Tests may be omitted only in areas in which internal controls are likely to be ineffective in preventing or detecting noncompliance; in which case, instances of the deficiencies are to be reported as findings.

When performing an audit of a nonprofit HUD-assisted entity, the Uniform Guidance, at 2 CFR 200.514(c)(3) and 2 CFR 200.515(b), state the auditor must:

- Plan tests of internal control over compliance for major programs to support a low assessed level of control risk of noncompliance for the assertions relevant to the compliance requirements for each major program.
- Perform tests of internal control over compliance as planned (unless the auditor has determined that internal control over some or all of the compliance requirements for a major program is likely to be ineffective).
- Issue a report on internal control that describes the scope and results of the auditor's tests of internal control and, where applicable, refers to a separate schedule of findings and questioned costs.

In addition, AU-C 935.20 states that the auditor should design and perform further audit procedures that include tests of the operating effectiveness of controls over each applicable compliance requirement if (a) the auditor's risk assessment includes an expectation of the operating effectiveness of controls over compliance for the applicable compliance requirements, (b) substantive procedures alone do not provide sufficient appropriate audit evidence, or (c) tests of controls over compliance are required by the governmental audit requirement.

Because of the requirements to test and report on the project's controls over compliance with HUD programs, an early planning consideration is the auditors' need to gain a further understanding of internal control in areas relating to the compliance requirements in the HUD audit guide and the *OMB Compliance Supplement*. The auditor's consideration of internal control over compliance is similar to the consideration of internal control over financial reporting discussed previously in this course. The same concepts apply regarding assessing risk, understanding internal control over compliance, and testing controls. However, the consideration of internal control over compliance is directed toward compliance with the provisions of laws, regulations, contracts, and grant agreements.

In obtaining an understanding of internal control relevant to compliance requirements, the auditor should perform risk assessment procedures as described in Lesson 1 to evaluate the design of the controls over compliance and determine if the controls have been implemented. In evaluating the design of a control over compliance, the auditor considers whether the control, individually or in combination with other controls, is capable of effectively preventing, or detecting and correcting, instances of noncompliance. The auditor considers the design of the control when deciding whether to consider its implementation (i.e., whether the control exists and the entity is using it).

The GAS/SA Audit Guide, Paragraph 9.19, states that procedures used to evaluate the effectiveness of the design of a control over compliance and its implementation might include (a) inquiries of entity personnel, (b) inspection of documents and reports, and (c) observation of the application of the specific controls. As noted above, these procedures should be performed regardless of whether the auditor would otherwise decide to obtain evidence to support an assessment of control risk below the maximum level. Previous paragraphs in this course discuss these audit procedures.

It is possible to design tests of controls over compliance that would simultaneously test compliance with laws and regulations. However, auditors ought to use caution in audits of both for-profit and nonprofit HUD entities.

Exhibit 2-1 lists examples of the types of inquiries that the auditors could make when gaining an understanding of internal control relevant to administering HUD programs.

Exhibit 2-1

Illustrative Inquiries for Gaining an Understanding of Compliance Controls over HUD Programs

- Are requests for withdrawals from the residual receipts account prepared by a competent person and approved by a member of management?
- Does the entity have controls to ensure that cash disbursements are eligible uses of project assets?
- Does a responsible member of management periodically review the tenant selection plan and the project's waiting list to determine if the entity's criteria for accepting and rejecting housing applicants is consistent with federal law?
- Are housing assistance payments vouchers, excess income reports, and other required reports prepared by a competent person, reviewed by a responsible member of management, and submitted to HUD on a timely basis?
- Does a responsible member of management regularly review the certifications and recertifications of tenant income?
- Are requests for withdrawals from the replacement reserve prepared by a competent person and approved by a member of management?
- Does the entity have a policy of conducting regular unit and property inspections?
- Does the entity (or management agent) have controls to ensure that the HUD-assisted project does not pay for expenses that are properly charged to another entity?
- Is a designated person responsible for ensuring that current editions of HUD handbooks are on hand?

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

17. What does the Uniform Guidance (2 CFR section 200.303) require in audits of nonprofit HUD entities?

    a. That internal control over federal awards be in compliance with the Green Book or the COSO framework.

    b. That internal controls are documented or evaluated prescriptively in accordance with the Green Book or the COSO framework.

    c. That the entity or the auditor reconcile all technical differences between the Green Book and the COSO framework that apply to the entity's internal control.

    d. That the entity's internal control system incorporates all 17 principles associated with the five components of internal control.

18. Which of the following statements best describes the effect of information technology (IT) on the internal control of a HUD-assisted entity?

    a. IT's effect on internal control is based more on the HUD entity's size than the complexity of the IT system.

    b. In compliance audits, auditors do not need to obtain an understanding of how the entity responds to IT risks.

    c. Much of a HUD entity's IT will likely be integrated with the general ledger, but some may not.

    d. The definition of IT in relation to the HUD entity is limited to off-the-shelf software or custom-developed applications.

19. Walkthroughs will help the auditor obtain an understanding of which of the following?

    a. The control environment.

    b. Communication.

    c. The financial reporting system.

    d. Monitoring.

20. Which component of internal control includes the policies and procedures that help ensure management directives are carried out?

    a. Control activities.

    b. Control environment.

    c. Monitoring.

    d. Risk assessment.

21. Independence Residences, a HUD-assisted entity, employs a property management company. How might this affect Independence's internal control?

    a. The property management company will be responsible maintaining the accounting records.

    b. The owner of Independence will be responsible for complying with the HUD requirements.

    c. The requirements in AU-C 402 related to service organizations supersede those about internal control in AU-C 315A.

    d. If the auditor has a thorough understanding of Independence and its owner, understanding property management controls is not necessary.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

17. What does the Uniform Guidance (2 CFR section 200.303) require in audits of nonprofit HUD entities? **(Page 354)**

    a. **That internal control over federal awards be in compliance with the Green Book or the COSO framework. [This answer is correct. In audits of nonprofit HUD entities, auditors need to consider that the Uniform Guidance (2 CFR section 200.303) states that the entity's internal controls over federal awards should be in compliance with the guidance in *Standards for Internal Control in the Federal Government* (the Green Book) or with COSO's *Internal Control—Integrated Framework* (the COSO framework), which is the most widely used framework in the U.S.]**

    b. That internal controls are documented or evaluated prescriptively in accordance with the Green Book or the COSO framework. [This answer is incorrect. Paragraph 9.05 of the GAS/SA Audit Guide clarifies the information in the Uniform Guidance to say that there is no expectation or requirement for a nonprofit HUD entity to document or evaluate internal controls prescriptively in accordance with the Green Book or the COSO framework.]

    c. That the entity or the auditor reconcile all technical differences between the Green Book and the COSO framework that apply to the entity's internal control. [This answer is incorrect. The GAS/SA Audit Guide, Paragraph 9.05, clarifies the guidance provided to nonprofit HUD entities in the Uniform Guidance. It states that there is no requirement or expectation for the entity or its auditor to reconcile technical differences between the Green Book and the COSO framework.]

    d. That the entity's internal control system incorporates all 17 principles associated with the five components of internal control. [This answer is incorrect. The AICPA Risk Assessment Guide discusses various aspects of the COSO framework. For example, observations and suggestions are included, when relevant, with discussion of the 17 principles associated with the five components of internal control. However, the guidance found in this risk assessment guide from the AICPA is different from the Uniform Guidance. Therefore, there is a better answer to this question.]

18. Which of the following statements best describes the effect of information technology (IT) on the internal control of a HUD-assisted entity? **(Page 357)**

    a. IT's effect on internal control is based more on the HUD entity's size than the complexity of the IT system. [This answer is incorrect. The effects of IT can be extensive, but the effect on internal control is related more to the nature and complexity of the system than to the client's size.]

    b. In compliance audits, auditors do not need to obtain an understanding of how the entity responds to IT risks. [This answer is incorrect. The GAS/SA Audit Guide explains that it is especially important in a compliance audit for the auditor to obtain an understanding of how the entity has responded to risks arising from IT. The information systems and programs may include controls related to direct and material compliance requirements, and therefore should be evaluated.]

    c. **Much of a HUD entity's IT will likely be integrated with the general ledger, but some may not. [This answer is correct. Most HUD projects and management agents use IT to process accounting and other transactions. Applications are run using standard software that is designed for rental properties and has report features that provide printouts of the components of man asset and liability balances. Although many of the applications are integrated with the general ledger, some, such as rent roll, may not.]**

    d. The definition of IT in relation to the HUD entity is limited to off-the-shelf software or custom-developed applications. [This answer is incorrect. While information systems may use off-the-shelf software or custom-developed applications, the auditor would also consider spreadsheets developed by end users that are used for accounting functions. How the client manages IT includes understanding the persons and third parties who support the IT infrastructure, along with those parties responsible for managing the deployment and integrity of the infrastructure.]

19. Walkthroughs will help the auditor obtain an understanding of which of the following? **(Page 364)**

    a. The control environment. [This answer is incorrect. The elements of the control environment include communication and enforcement of integrity and ethical values and commitment to competence, among other things. The internal control issues covered by the control environment are not those which would be illuminated by performance of a walkthrough.]

    b. Communication. [This answer is incorrect. Communication may take the form of policy manuals, memorandums, oral or electronic communications, etc. Walkthroughs, as defined, are typically focused on other areas.]

    c. **The financial reporting system. [This answer is correct. A common method of obtaining an understanding of the design and implementation of the financial reporting system for a significant transaction class is to trace a transaction through the various processing steps and related controls from initiation to inclusion in the general ledger and financial statements. This is commonly referred to as a "walkthrough" procedure.]**

    d. Monitoring. [This answer is incorrect. The elements of an entity's monitoring process include (1) ongoing and/or separate evaluations and (2) evaluation and reporting of internal control deficiencies. Walkthrough procedures, as defined, would not help the auditor obtain an understanding of this process.]

20. Which component of internal control includes the policies and procedures that help ensure management directives are carried out? **(Page 367)**

    a. **Control activities. [This answer is correct. *Control activities* are the policies and procedures that help ensure that management directives are carried out. That is, control activities are those actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting.]**

    b. Control environment. [This answer is incorrect. The *control environment* sets the tone of an entity and influences the control consciousness of its people. It includes the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control.]

    c. Monitoring. [This answer is incorrect. *Monitoring* is a process by which an entity assesses the quality of its internal control over time. Monitoring involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary.]

    d. Risk assessment. [This answer is incorrect. As a component of internal control, *risk assessment* is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives.]

21. Independence Residences, a HUD-assisted entity, employs a property management company. How might this affect Independence's internal control? **(Page 371)**

    a. **The property management company will be responsible maintaining the accounting records. [This answer is correct. Typically, the property management company's broad responsibilities will include maintaining the accounting records for the HUD-assisted property, including billing and collecting rent and processing and paying accounts payable. The auditor will need to keep who has responsibility for what in mind when performing Independence's annual audit.]**

    b. The owner of Independence will be responsible for complying with the HUD requirements. [This answer is incorrect. Compliance with HUD requirements in the regulatory agreement and other applicable laws and regulations typically falls under the broad responsibilities of the property management company, not the owner of the HUD entity.]

c. The requirements in AU-C 402 related to service organizations supersede those about internal control in AU-C 315A. [This answer is incorrect. Because the property management's responsibilities are significant to the HUD-assisted entity's internal control over financial reporting, AU-C 402 needs to be viewed together with, rather than separate from, the basic requirements for consideration of controls that are prescribed by AU-C 315A. The requirements in AU-C 402 do *not* take the place of or supersede the requirements in AU-C 315A.]

d. If the auditor has a thorough understanding of Independence and its owner, understanding property management controls is not necessary. [This answer is incorrect. AU-C 402.11 requires the auditor to ensure that he or she has obtained a sufficient understanding or test of the nature and significance of services provided by a service organization (not just an understanding of the entity and its owner) and their effect on the client's internal control to provide a basis for identifying and assessing risks of material misstatement.]

Lesson 3: Audit Planning Decisions and Judgments, Sampling, Workpapers, Initial Engagements, and Group Financial Statements

INTRODUCTION

Lesson 3 continues this course's discussion of pre-engagement activities and audit planning for HUD audits and begins by taking a look at the audit planning decisions and judgments that a HUD auditor may have to make during the course of the engagement.

This is followed by discussions of audit sampling, detailed audit plans and workpapers, and special planning considerations that may affect the initial audit of a HUD-assisted entity. Finally, Lesson 3 concludes with a discussion about auditing group financial statements.

Learning Objectives:

Completion of this lesson will enable you to:

- Recognize the audit planning decisions and judgments a HUD auditor may need to make.
- Identify best practices for the use of audit sampling, detailed audit plans, and other workpapers in a HUD audit.
- Determine what additional procedures may be necessary in an initial HUD audit or an audit of group HUD financial statements.

MAKING AUDIT PLANNING DECISIONS AND JUDGMENTS

The information the auditor obtains about the entity and its environment, including its HUD programs, by performing risk assessment procedures is used to make several important planning decisions and judgments. The primary planning decisions and judgments for the financial statement audit based on this information are as follows:

- The materiality level for the financial statements taken as a whole (preliminary planning materiality).
- Materiality for particular items of lesser amounts than planning materiality.
- The risks of material misstatement at the financial statement level.
- The overall audit strategy (a collective group of judgments about the audit approach, including overall responses to risks).
- Performance materiality at the individual class of transactions, account balance, or disclosure level.
- Risks of material misstatement at the relevant assertion level related to classes of transactions, account balances, and disclosures.
- The specific nature, timing, and extent of further audit procedures.

Because the audit planning process is iterative and continuous, some risk assessment procedures are performed to consider audit risk and materiality at the financial statement level and the judgments about those matters in turn affect the considerations at the relevant assertion level for account balances, transaction classes, and disclosures.

The additional planning decisions and judgments relative to the compliance portion of a HUD audit include (a) program materiality, (b) the risks of material noncompliance, and (c) the specific nature, timing, and extent of further compliance audit procedures.

The GAS/SA Audit Guide, Paragraph 10.06, states that planning (as well as conducting and evaluating) compliance testing requires the auditor to exercise professional judgment. It provides the following factors that the auditor might consider:

- The assessment of audit risk of noncompliance.
- The assessment of materiality.
- The evidence obtained from other auditing procedures.
- The amount and diversity or homogeneity of program expenditures.
- The length of time that the program has operated.
- Changes in the program's conditions.
- Current and prior auditing experience with the program, especially findings in previous audits and other evaluations (such as inspections, program reviews, or system reviews).
- The extent to which the program is conducted by subrecipients and related monitoring activities.
- The extent to which the program contracts for goods or services.
- The level of program reviews or other forms of independent oversight.
- The expectation of compliance or noncompliance with the direct and material compliance requirements.
- The extent and complexity of computer processing used to administer the program.

Most of the planning decisions and judgments made for the financial statement portion of a HUD audit have counterparts in the compliance audit planning process. Planning decisions for the financial statement audit interact with and ought to be considered with the planning decisions for the compliance audit. Considerations for making planning decisions for the compliance portion of a HUD audit are discussed later in this section.

There is an element of audit risk in both the "financial" and "compliance" parts of the HUD audit engagement. The concept of audit risk in connection with the audit of the entity's financial statements, as well as the auditor's consideration of the risk that the project owner has not complied with laws and regulations that have a direct and material effect on each major HUD program, are also discussed later in this section.

Determining Materiality at the Financial Statement Level

According to AU-C 320.10, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. The need to establish planning materiality is directly related to the auditor's objective of obtaining reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be material to the financial statements. The auditor uses the concept of materiality both in (a) planning and performing the audit and (b) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. These two perspectives of the concept are usually referred to in practice as (a) *planning materiality* and (b) *evaluation materiality*.

***Government Auditing Standards* Requirements.** The Yellow Book, Paragraph 6.03, explains that additional materiality considerations might apply when the audit is conducted under *Government Auditing Standards* because of the public accountability of entities receiving government funding, various legal or regulatory requirements, and the sensitivity of government programs. Thus, in a HUD financial audit conducted in accordance with the Yellow Book, it may be appropriate to consider lower materiality levels than would be used in a GAAS-only audit.

Establishing Planning Materiality. The auditor's determination of materiality, according to AU-C 320.04, is a matter of professional judgment and is affected by the auditor's perception of the financial information needs of users of the financial statements. AU-C 200.07 observes that generally misstatements or omissions are viewed as material if there is a substantial likelihood that, individually or in the aggregate, they would influence the judgement made by a reasonable user based on the financial statements, and that materiality decisions involve both quantitative and qualitative considerations. In determining planning materiality, the focus is generally on quantitative factors. Thus, auditors have historically used some common rules of thumb in establishing planning materiality.

These rules of thumb generally apply a percentage to a benchmark amount from the financial statements. AU-C 320.A6 acknowledges the appropriateness of using this approach as a starting point in determining materiality for the financial statements as a whole and suggests the following factors that may affect the identification of an appropriate benchmark:

- Elements of the financial statements (assets, liabilities, equity, revenue, expenses).
- Focus of financial statement users' attention on particular items (for evaluating financial performance, for example, profit, revenue, or net assets).
- Nature of the entity, where it is in its life cycle, and the industry and economic environment in which it operates.
- Ownership structure of the entity and the way it is financed (for an entity financed solely by debt, for example, users may put more emphasis on assets and claims on assets than on earnings).
- Relative volatility of the benchmark.

Selecting a Benchmark. Selecting a benchmark may be considered the most important aspect of determining planning materiality because, as explained in AU-C 320.A10 and below, there is a relationship between the percentage and the chosen benchmark. In practice, a particular range of percentages is commonly associated with a particular benchmark. Some auditors favor benchmarks that are not volatile and that are, thus, more stable and predictable. AU-C 320.A6 acknowledges that the relative volatility of the benchmark is a factor to consider in identification of an appropriate benchmark. For many HUD entities, total assets or total revenue provides a sound benchmark. Using either total assets or total revenue as a benchmark has the advantages of relative stability, predictability, and representativeness of entity size. Nevertheless, because it is unlikely that such benchmarks will adequately address user needs for all entities and circumstances, the auditor needs to identify whether there are financial statement items on which, for the particular entity, users' attention tends to be focused. The auditor uses professional judgment considering the relevant factors when determining planning materiality for a specific entity. If a financial statement item is more important to users than total assets or total revenue, then the auditor ought to determine the planning materiality amount using that financial statement element as the benchmark.

Regardless of the benchmark used for planning the extent of audit testing, the auditor needs to be satisfied that the resulting planning materiality provides an appropriate amount for determining the nature, timing, and extent of planned procedures that will be adequate to provide reasonable assurance that the financial statements are free from material misstatement, even if a different materiality amount is used for evaluation of audit differences. A planning materiality amount is used primarily to plan the extent of audit testing, but does not necessarily provide a basis for determining the adequacy of other aspects of audit planning, namely, the nature and timing of procedures. Also, as explained earlier, the choice of a materiality amount for planning purposes does not predetermine what will be relevant in evaluating detected misstatements at the conclusion of the audit. The auditor may use an amount based on a "size-of-business" benchmark such as assets or revenues to plan the scope of audit testing, but still use a "percentage-of-earnings" amount for the evaluation of audit findings. Thus, if assets or revenue are used to determine planning materiality, the auditor nonetheless probably would use the amount based on earnings to determine materiality for evaluating those audit differences that affect the income statement.

Selecting a Percentage. There are no authoritative percentage guides for materiality. AU-C 320.A10 explains that a relationship exists between the percentage and the chosen benchmark. For example, a percentage applied to profit from continuing operations before tax will normally be higher than a percentage applied to total revenue. AU-C 320, however, contains no guidance or specific examples of appropriate percentages. Nevertheless, certain guidelines have evolved in audit practice. Using total assets or total revenue as a benchmark means the audit scope will be driven by the size of the entity. Many auditors believe intuitively that this is appropriate because it agrees with their own past experience in making judgments about audit scope. Also, for intuitive reasons, many auditors believe that the materiality percentage ought to be adjusted in relation to the size of an entity. They believe the percentage can be larger for a very small entity to recognize the practical limits on the effectiveness of audit procedures and smaller for a very large entity to recognize the increased risks that usually accompany bigness and the fact that a large enough absolute amount is often considered material. Though outside the scope of this course, the practice aids in *PPC's Guide to HUD Audits* provide a sliding scale percentage that can be applied to total assets or total revenue, which might be suitable for the circumstances of the typical HUD entity. The reduction of the percentages as the benchmark amount increases may also serve to prevent the planning materiality amount from becoming disproportionately large in relation to the income statement. The practice aids also include other rules of thumb that may be appropriate.

Determining Materiality for Particular Items of Lesser Amounts. AU-C 320.10 indicates that, in addition to determining a planning materiality amount for the financial statements taken as a whole, the auditor should consider whether, in the specific circumstances of the entity, misstatements of particular classes of transactions, account balances, or disclosures of lesser amounts than planning materiality would influence the judgment made by a reasonable user. Any such amounts determined represent lower materiality levels to be considered in relation to the particular classes of transactions, account balances, or disclosures in the financial statements for audit planning purposes. In other words, in addition to determining materiality at the financial statement level, the auditor determines whether there are particular classes of transactions, account balances, or disclosures for which a lower planning materiality amount is appropriate based on user perceptions of the particular items. HUD has specific financial reporting requirements, and auditors may find that lower materiality levels must be applied to some financial statement items.

The auditor ought to consider consulting with management and those charged with governance about whether there are particular financial statement items of lesser amounts than planning materiality that users would regard as material. However, the determination of such items is a decision based on consideration of several qualitative factors. (AU-C 320.A13 lists other factors to consider.) Lower levels of materiality for particular items in the financial statements should be documented.

Reconsider Materiality throughout the Audit. Planning materiality decisions need to be reconsidered as the audit progresses. AU-C 320.12 states that the auditor should revise materiality levels if the auditor becomes aware of information during the audit that would have caused the auditor to determine a different amount(s) initially. Because the calculation made during initial planning may use unadjusted financial information, the amounts in the annual audited financial statements may differ. If the auditor becomes aware of changes that would have affected the determination of planning materiality, adjustments should be made. AU-C 320.13 indicates that if the auditor concludes a lower materiality than initially determined is appropriate, the auditor should determine whether performance materiality has to be revised and whether the nature, timing, and extent of further audit procedures remain appropriate. If planning materiality based on unadjusted amounts is too large, for example, then audit scope might not have been sufficient. If planning materiality based on unadjusted amounts was too small, then the audit would be less efficient than would have been possible because the auditor will have done more audit work than was necessary.

Determining Performance Materiality for the Financial Audit

The auditor's objective is to perform the audit to obtain reasonable assurance of detecting misstatements that the auditor believes could be large enough, individually or in the aggregate, to be quantitatively material to the financial statements. For this purpose, the auditor needs to establish performance materiality amount(s) at the individual account balance, class of transaction, or disclosure level.

Performance materiality is the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. When applicable, performance materiality also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.

Performance materiality is distinguishable from tolerable misstatement. As explained in AU-C 320.A3, the application of performance materiality to a particular audit sampling procedure is called *tolerable misstatement*. AU-C 530.A6 also provides the guidance that tolerable misstatement may be the same amount or an amount smaller than performance materiality.

Professional standards do not discuss precisely how performance materiality is to be determined. The approach suggested by the authors is to determine performance materiality as a percentage of the auditor's judgment about the amount material to the financial statements taken as a whole. The percentage used is based on the auditor's expectation of uncorrected and undetected misstatements. Using this approach, a common rule of thumb is to calculate performance materiality as a fraction between 50% and 75% of materiality at the financial statement level (and materiality for items of lesser amounts, if applicable) with the percentage being increased from 50% as the likelihood of uncorrected and undetected misstatements decreases. The authors believe that the larger adjustment of 75% will be satisfactory for most HUD audits.

Determining Individually Significant Dollar Items. A concept closely related to performance materiality is individually significant items (ISI). This term encompasses two types of items in a financial statement component, both of which may be considered high risk. These include:

a. Unusual items (that is, items that have audit significance by their nature).

b. Individually significant dollar items.

The appropriate cutoff dollar amount for individually significant items depends on the distribution by size of the individual items comprising the balance. Many auditors find it convenient to determine the amount for which all items of that amount or larger that will be selected by using tolerable misstatement or a fraction thereof. A rule of thumb that typically minimizes the need to use audit sampling (or the total number of items tested from both ISIs and sample size when sampling is used) is to select all items that are one-third of tolerable misstatement or larger. However, the auditor may use any amount less than tolerable misstatement to limit the remaining balance to an amount that reduces the risk of material misstatement to an acceptable level. One approach is to reduce the fraction of tolerable misstatement used for individually significant items from one-third as the risk of material misstatement for the assertion being tested increases.

This course recommends calculating individually significant dollar items either using the rule of thumb of one-third of tolerable misstatement or another amount, not to exceed tolerable misstatement. Individually significant items often are used for making scope decisions in entity engagements in the following areas:

- *Accounts Payable*—determining the size of cash disbursements to be examined in the subsequent period in the search for unrecorded liabilities.

- *Expenditures*—determining the size of cash disbursements to be examined for significant expenditure classifications.

- *Litigation, Claims, and Assessments*—specifying materiality levels for an attorney to use in responding to an audit inquiry letter.

The authors believe auditors can use the larger of total revenue or total assets as the base, even if the result is a relatively high individually significant item limit. As previously mentioned, if the amount using the larger of total assets or total revenue is too high to give auditors their desired level of coverage, the base may be adjusted downward on an individual basis.

Clearly Trivial Misstatements. As indicated at AU-C 450.05–.11, auditors are required to accumulate and evaluate misstatements detected during the audit, other than those that are clearly trivial. Clearly trivial is not synonymous with not material. *Clearly trivial* misstatements of reported amounts are of a wholly smaller order of magnitude than those determined to be immaterial and are clearly inconsequential, individually or in the aggregate, measured against any criteria of size, nature, or circumstance. The amount determined to be clearly trivial is the level for accumulating misstatements during the concluding audit work and is sometimes called the nonposting threshold. Misstatements detected in a particular audit area below this amount are not posted to the summary of audit differences. The clearly trivial misstatement amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered. AU-C 450.12 requires the auditor to document the amount that, below which, misstatements would be considered clearly trivial.

Assessing Risks of Material Misstatement at the Financial Statement Level

Audit risk in a financial statement audit is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement. In this sense, audit risk is the risk of material misstatement remaining in the financial statements after the audit. Audit risk cannot be precisely measured as a percentage; thus, consideration of audit risk is necessarily judgmental, not mathematical.

According to AU-C 315A.03, the auditor's objective is to identify and assess the risks of material misstatement due to error or fraud at both the financial statement level and at the relevant assertion level. These risks are identified and assessed by obtaining an understanding of the entity and its environment including its internal control, and this understanding provides a basis for designing and implementing responses to the assessed risks of material misstatement. AU-C 315A.26 specifically requires the auditor to identify and assess risks of material misstatement at both the (a) financial statement level, and (b) for classes of transactions, account balances, and disclosures at the relevant assertion level. AU-C 315A.27b requires that, for this purpose, the auditor should assess the identified risks and evaluate whether they relate more pervasively to the financial statements and potentially affect many assertions.

Responding to Risks at the Financial Statement Level. The auditor should design and implement overall responses to address the assessed risks of material misstatement at the financial statement level. AU-C 330.A1 provides guidance to auditors when determining overall responses to address risks of material misstatement at the financial statement level. These responses may include:

- Emphasis to the audit team to use professional skepticism.
- Assigning staff with higher experience levels or specialized skills, or using specialists.
- Increasing the level of supervision.
- Using a greater degree of unpredictability in selecting audit procedures.
- Changing the nature, timing, and extent of substantive procedures (e.g., instead of interim testing shift testing to period end or modify the nature of audit procedures to obtain more persuasive evidence).

In addition, the auditor should consider any specific relevant assertions that might be affected by the overall risks and develop responses at that level when designing the nature, timing, and extent of further audit procedures.

To introduce an element of unpredictability, the authors believe the auditor needs to avoid always selecting only items above a cutoff dollar amount, particularly when that cutoff amount does not vary significantly from year to year. The auditor can make a haphazard selection to test items below the cutoff amount to avoid providing client personnel with a roadmap of how to circumvent the audit approach.

Because there is always a risk of management override of controls, AU-C 240.29 states that certain overall responses are required in every audit, as follows:

- Auditors should consider the knowledge, skill, and ability of individual engagement team members and the fraud risk assessment when assigning and supervising personnel.
- Auditors should evaluate the client's selection and application of accounting principles, especially in subjective areas.
- Auditors should incorporate an element of unpredictability in the selection of audit procedures from year to year.

Other overall responses may also be appropriate to address identified fraud risks.

Before considering how to assess the risk of material misstatement at the assertion level the auditor needs to understand several basic concepts, including:

- The audit risk model.
- The risk of material misstatement.
- Financial statement assertions.

The Audit Risk Model. AU-C 200.14 explains that *audit risk* is the risk of an auditor expressing an inappropriate opinion on materially misstated financial statements. It further explains that audit risk is a function of the risks of material misstatement and detection risk. AU-C 200.14 defines these terms as follows:

- *Risk of Material Misstatement*—The risk that the financial statements are materially misstated prior to the audit. This consists of two components, described as follows at the assertion level:
    - *Inherent Risk*—The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.
    - *Control Risk*—The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.
- *Detection Risk*—The risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Detection risk is determined by the effectiveness of the nature, timing, and extent of further audit procedures applied and is composed of test of details risk (TD) and substantive analytical procedures risk (AP).

Risk of Material Misstatement. The combined effect of inherent risk (IR) and control risk (CR) is the risk of material misstatement (RMM). In other words, the aggregate risk of material misstatement in the risk model is expressed as follows:

$$\text{RMM} = \text{IR} \times \text{CR}$$

The auditor assesses those two risks and then designs audit procedures to reduce detection risk to an appropriately low level. Fraud risks affect both inherent and control risk. Therefore, the auditor's assessments of inherent and control risk include consideration of the risk of material misstatement due to fraud.

Inherent risk and control risk are the entity's risks and exist independently of the audit. The risk of material misstatement (RMM), the product of IR and CR, is the auditor's combined assessment of the two risks. The auditor may make an overall, or combined, assessment of the risk of material misstatement at the relevant assertion level or make separate assessments of inherent risk and control risk and then combine them. Thus, at the relevant assertion level, the audit risk model is as follows:

$$\text{AR} = \text{RMM} \times \text{DR}, \text{ where DR} = \text{TD} \times \text{AP}$$

The greater the risks of material misstatement, the less detection risk can be accepted and as a result, auditors would need to obtain more persuasive audit evidence.

In planning a particular test of details, the detection risk is established by the following relationship:

$$\text{TD} = \frac{\text{AR}}{\text{RMM} \times \text{AP}}$$

This model is not intended to be a mathematical formula including all factors that influence the substantive procedures planned and performed. For example, AU-C 330.18 requires that no matter what the assessed risks of material misstatement are, the auditor should design and perform substantive procedures for all relevant assertions related to each material class of transactions, account balance, and disclosure. Further, AU-C 315A.05 indicates that risk assessment procedures, by themselves, do not provide sufficient appropriate evidence on which to base an opinion. Thus, inherent risk or control risk cannot be assessed at a level so low that detection risk calculated using the formula would be maximum, or 100%, resulting in no substantive procedures.

Assessing the Risks of Material Misstatement at the Relevant Assertion Level for the Financial Audit

AU-C 315A.04 defines a *relevant assertion* as one "that has a reasonable possibility of containing a misstatement or misstatements that would cause the financial statements to be materially misstated." For example, the valuation assertion for cash is ordinarily not relevant unless foreign currency translation is involved. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement in each significant class of transactions, account balance, and disclosure
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertions.

Determination of whether an assertion is relevant is made without regard to the effect of internal controls.

The risks of material misstatement may be assessed in quantitative or qualitative terms. The assessment at the relevant assertion level, whether made in quantitative terms (e.g., percentages) or nonquantitative terms (e.g., high, moderate, or low) is a judgment rather than a precise measurement of risk. The auditor needs to have an appropriate basis for the judgment about risk at the relevant assertion level. This basis is obtained through the risk assessment procedures performed to obtain an understanding of the entity and its environment, as described in Lesson 2. The only time that use of the formula for the audit risk model and specific percentages are necessary is when statistical sampling is used, but the formula can be useful in other circumstances as well. The auditor's determination of the components of the risk model is always made subjectively. Even when the auditor quantifies the components as a percentage, the judgment is subjective and not a mathematical calculation.

Matters that represent risks at the financial statement level may also result in risks at the assertion level. Because of their nature, accounting estimates and related parties can both have that effect. As a result, AU-C 540A, *Auditing Accounting Estimates, Including Fair Value Accounting Estimates, and Related Disclosures*, and AU-C 550, *Related Parties*, require certain specific procedures to be performed as part of identifying and assessing the risks of material misstatement in accordance with AU-C 315A.

Accounting Estimates. AU-C 540A.10–.11 indicates that as part of risk assessment, the auditor should evaluate the degree of estimation uncertainty of accounting estimates and determine whether any having a high degree of estimation uncertainty represents significant risks. The degree of estimation uncertainty associated with a particular accounting estimate may be influenced by a number of factors, as described in AU-C 540A.A45–.A46. Further, AU-C 540A.12 indicates that the auditor is required to determine, based on the risk assessment, whether (a) management has appropriately applied GAAP to the accounting estimate, (b) the method for making the estimate is appropriate and applied consistently, and (c) any change in the estimate or method from the prior period is appropriate.

Related Parties. AU-C 550.20 states that the auditor should identify and assess the risks of material misstatement associated with related-party relationships and transactions to determine whether they represent significant risks. It also requires that in making this determination, the auditor should treat identified related-party transactions that are significant unusual transactions as giving rise to significant risks. In addition, AU-C 550.21 indicates that if related party fraud risk factors are identified, the auditor should consider them in identifying and assessing risks of material misstatement due to fraud.

Disclosures. AU-C 300, *Planning an Audit*, contains a discussion of risks factors to consider related to disclosures. Auditors need to consider disclosures when assessing risks and determining the audit response, which may affect the assessed risk of material misstatement. Auditors are encouraged to consider the following early in the audit planning process:

- Significant new or revised disclosures requirements due to changes in the entity's environment, financial condition, or activities.
- Significant new or revised disclosures requirements due to changes in the applicable financial reporting framework (GAAP).
- The potential need for an auditor's specialist to assist with auditing of disclosures.
- Disclosure-related matters the auditor may need to discuss with those charged with governance.
- Risks associated with information for disclosures from sources outside of the entity's general or subsidiary ledgers.

When assessing risks of material misstatement related to disclosures, the auditor considers both qualitative and quantitative information. The following are examples of qualitative information in disclosures that could be relevant when assessing risk of material misstatement:

- Terms and compliance with debt covenants and disclosers about liquidity, especially when an entity is in financial distress.
- Disclosure of events and circumstances that brought about recognition of an impairment loss.
- Discussion of estimation uncertainty for accounting estimates, including descriptions of assumptions used, such as those made about future events.
- Description of the nature of an accounting policy change.
- Description of the expected impact of a new or revised financial reporting requirement due to changes in the applicable financial reporting framework (GAAP).
- Information about how recognized amounts related to share-based payments were determined.
- Disclosures about relate-party relationships and transactions.
- Discussion of sensitivity analysis, such as changes in assumptions used in valuation techniques.

This list is not exhaustive, and the auditor needs to consider information gathered while obtaining an understanding of the entity specific to disclosure requirements applicable to the entity. This includes audits of smaller entities, even though the disclosures for such entities may be less detailed or complex.

Determining Significant Audit Areas. The next step is to identify those audit areas that are significant. The following factors need to be considered in determining which audit areas are significant:

- Relative materiality of the account balances, transactions, or disclosures to the overall financial statements.
- Relative significance of the transaction classes to the entity's operations or the overall financial statements (for example, because of either the materiality of account balances affected or volume of transactions flowing through the accounts during the period).
- The susceptibility of the account balances, transaction classes, or disclosures to fraud, including both misappropriation and similar loss of related assets and intentional misstatement by management.
- Audit areas that for other reasons (such as complex calculations, difficult or contentious accounting issues, new accounting standards, need for judgment, unusual nature of transactions, past history of significant adjustments, or other engagement risk factors) have a high assessed level of inherent risk or contain significant risks.

- Disclosures that require additional effort at the account balance level in an audit area to ensure accuracy and completeness.

An audit area is a grouping of related account balances, transaction classes, and disclosures. For example, the accounts receivable and revenue audit area includes revenue from contracts with customers, receivables from customers; collection of consideration from customers (cash receipts); the uncollectible-receivables allowance and expense accounts, and disclosures related to all those accounts. An audit area is a mixture of transactions, balances, and disclosures related to a particular area of an entity's operations. There are various ways of organizing an audit into areas. Some auditors use transaction cycles, such as the revenue cycle and expenditure cycle. Other auditors prefer to use balance sheet and related income statement account balances, which is the approach used by PPC.

Major transaction class categories typically include revenues, purchases, cash receipts, and cash disbursements. Transaction classes are accumulated during the period covered by the income statement in account balances. Thus, revenue, for example, is both an account balance and a transaction class and significance may be evaluated based on the account balance. Other transaction classes, such as cash receipts and cash disbursements, may affect many account balances, and significance is evaluated by the volume of the transactions during the period.

Materiality of Reported Amounts to the Financial Statements. One element of significance is the dollar amount of an account balance, transaction, or quantitative disclosure in relation to the auditor's judgment of the amount material to the financial statements taken as a whole. Any audit area that includes one or more material reported amount is a significant audit area. Judgment is needed even in making these quantitative comparisons because reported amounts may not be completely misstated.

Relative Significance to the Financial Statements. As indicated at AU-C 315A.28–.31, the auditor's risk assessment should include an evaluation of whether the following risks are present:

- Significant risks that require special audit consideration.
- Risks for which substantive procedures alone do not provide sufficient appropriate evidence.

Those risks are discussed in the following two subsections.

Significant Risks Requiring Special Audit Consideration. AU-C 315A.28 indicates that, as part of his or her risk assessment, the auditor should determine whether any of the risks identified are significant risks. That determination excludes the effects of identified controls related to the risk. AU-C 315A refers to such risks as risks that require special audit consideration. In other words, the auditor's determination of significant risks is based solely on the consideration of inherent risk. The AICPA Risk Assessment Audit Guide notes in paragraph 5.31 that in most audits one or more significant risks normally arise. It observes with respect to the determination of significant risk that in a situation in which the auditor assesses inherent risk as high, moderate, or low, a significant risk may be one that is higher than high and, thus, requires special audit consideration. Thus, a good rule of thumb is that every audit includes at least one significant risk, and the response to significant risk needs to include modified or additional procedures beyond what would ordinarily be performed.

According to AU-C 315A.29, the auditor should evaluate whether risks are significant risks by considering the following:

- Is the risk a risk of fraud or theft?
- Is the risk related to recent significant economic, accounting, or other developments?
- Are the transactions complex?
- Does the risk involve significant transactions with related parties?
- Is there a relatively high degree of subjectivity in the measurement of the financial information related to the risk?
- Does the risk involve significant unusual transactions?

An affirmative answer to any of these questions is likely to indicate the need for a specific audit response and, thus, a determination that the risk is a significant risk because it requires special audit consideration. Risks of material misstatement due to fraud are always significant risks. Risks of material misstatement due to error also may be deemed significant risks depending on their nature. The AICPA Risk Assessment Audit Guide suggests that it may be helpful to compare all high inherent risks to each other to assist with the identification of significant risks. In other words, by comparing all inherent risks to each other, an inherent risk that is higher than the ordinary high may be more apparent.

Every audit is likely to have at least one significant risk, but identifying too many risks as significant may be counterproductive. The AICPA Risk Assessment Audit Guide (in the observations and suggestions following Paragraph 5.31) cautions that the unnecessary designation of too many risks as significant risks can impair the efficiency of the audit. Also, if the auditor plans to rely on the operating effectiveness of controls relating to a significant risk, the auditor cannot use evidence obtained in prior periods about the effectiveness of such controls.

Risks for Which Substantive Procedures Alone Are Not Sufficient. As part of the auditor's risk assessment, the auditor might identify risks for which it is not possible or practicable to reduce detection risk at the relevant assertion level to an acceptably low level with audit evidence obtained only from substantive procedures; that is, substantive procedures alone will not be sufficient. Such risks often occur in audit areas in which there is highly automated processing with little or no manual intervention, that is, situations in which a significant amount of the entity's information is initiated, authorized, recorded, processed, or reported electronically. Accordingly, auditors are required by AU-C 315A.31 to understand and evaluate controls related to risks for which substantive procedures alone are not sufficient. The assessment of the risk of material misstatements and planned responses should be documented.

Planning the Compliance Audit

Assessing Risk of Noncompliance. In the compliance audit of a HUD project, the auditor is required to determine whether the recipient has complied with the provisions of laws, regulations, contracts, and grant agreements that may have a direct and material effect on each of its major HUD programs. Thus, when developing the audit plan, the auditor should assess not only the risk that noncompliance may cause a material misstatement of the financial statements, but also the risk that noncompliance may have a material effect on HUD program requirements.

Audit Risk of Noncompliance. AU-C 935.11 explains that *audit risk of noncompliance* is the risk of an auditor expressing an inappropriate opinion on compliance when material noncompliance exists. It is a function of the risk of material noncompliance and the detection risk of noncompliance. Thus, the components of audit risk in an audit of compliance are as follows:

- *Risk of Material Noncompliance.* The risk that material noncompliance exists prior to the audit. It consists of the following:
  - *Inherent Risk of Noncompliance.* The susceptibility of a major program's compliance requirement to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.
  - *Control Risk of Noncompliance.* The risk that noncompliance with a compliance requirement that could occur and that could be material to a major program, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.
- *Detection Risk of Noncompliance.* The risk that the procedures performed by the auditor to reduce audit risk of noncompliance to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated, with other instances of noncompliance.

According to Paragraph 6.38 of the GAS/SA Audit Guide, the auditor may evaluate inherent risk of noncompliance and control risk of noncompliance either combined or individually when identifying and assessing the risks of material noncompliance. In identifying and assessing such risks, the auditor might consider several factors, including the following:

- The complexity of the compliance requirements subject to audit that are direct and material, their susceptibility to noncompliance, and the length of time the entity has been subject to them.
- The auditor's observations about the entity's compliance with the compliance requirements in prior years.
- The potential effect of noncompliance with the compliance requirements on the entity.
- The amount of judgment needed to satisfy the compliance requirements.
- The auditor's assessment of the risks of material misstatement in the financial statement audit.

Detection Risk of Noncompliance. In determining an acceptable level of detection risk, the auditor considers the assessed inherent risk and control risk and the extent to which he or she wants to limit audit risk related to the major program. As assessed inherent risk and control risk decrease, the acceptable level of detection risk increases. As a result, the auditor might be able to alter the nature, timing, and extent of compliance tests based on the assessments of inherent risk and control risk.

Assessing the Risk of Material Noncompliance. The GAS/SA Audit Guide, Paragraph 6.40, explains that when identifying and assessing the risk of material noncompliance, the auditor should:

- Identify risks and related controls when obtaining an understanding of the entity and its environment.
- Relate the identified risks to what could go wrong at the relevant compliance level.
- Consider whether the likelihood and magnitude of the risks could result in noncompliance with requirements subject to audit that have a direct and material effect on a major program.

Documenting the Audit Risk of Material Noncompliance. The auditor's assessment of the risk of material noncompliance (i.e., the combined inherent and control risk) for purposes of determining the extent and nature of compliance testing for HUD programs should be documented. This information should be considered in developing an overall audit strategy and in establishing the scope of audit procedures. The auditor should note that when a single system of internal controls exists (as is the case in most HUD-assisted entities), the documentation of significant information about the entity can be done once for financial audit purposes and does not have to be duplicated for the compliance audit purposes.

Determining Materiality in the Compliance Audit. This discussion focuses on the use of materiality in planning the compliance portion of the HUD audit. As discussed earlier in this section, the auditor makes a preliminary judgment about materiality for the financial statements taken as a whole and uses that judgment in planning the nature, timing, and extent of audit procedures. When auditing compliance with requirements governing HUD programs, the auditor also considers materiality at the HUD program level. As discussed in the following paragraphs, the auditor's assessment of materiality for a specific instance of noncompliance will depend on the particular compliance requirement that is being evaluated and may be affected by several factors.

AU-C 935.13 states that the auditor sets materiality levels in a compliance audit for the following purposes:

- Determining the nature and extent of risk assessment procedures.
- Identifying and assessing risks of material noncompliance.
- Determining the nature, timing, and extent of further audit procedures.
- Evaluating compliance with applicable compliance requirements subject to audit that are direct and material.
- Reporting findings of noncompliance and other matters.

The auditor's consideration of materiality is usually in relation to a federal award program as a whole. However, a governmental audit requirement may specify a different level of materiality for certain purposes. In a HUD audit, the auditor considers a lower level of materiality for purposes of reporting audit findings than for other purposes. In the context of a Single Audit, Paragraph 6.50 of the GAS/SA Audit Guide explains that materiality for an audit finding under the Uniform Guidance is different (and generally lower) than the materiality used for (a) planning and performing the Single Audit; (b) planning, performing, evaluating the results of, and reporting on the financial statement audit; and (c) expressing an opinion on compliance. The same concepts apply in compliance audits performed in accordance with the HUD audit guide.

Paragraph 10.10 of the GAS/SA Audit Guide indicates that materiality is affected by:

- the nature of the compliance requirement, which might not be quantifiable in monetary terms,
- the nature and frequency of noncompliance identified with an appropriate consideration of sampling risk, and
- qualitative considerations, such as the needs and expectations of federal agencies.

The auditor has to plan the compliance audit of major HUD programs so that there is only a relatively low risk of failing to detect instances of noncompliance with requirements governing each HUD program that, when taken together, would be material to the program. The consideration of materiality in the compliance audit of a HUD program differs from that in the audit of financial statements. In the audit of financial statements, the auditor considers materiality in relation to the financial statements being audited. However, when auditing compliance with requirements of HUD programs, the auditor considers materiality at the major program, compliance requirement, and audit finding levels.

Materiality for Purposes of Assessing Compliance with Specific Requirements. The HUD audit guide and the Uniform Guidance require the auditor to test and opine on the entity's compliance with specific requirements applicable/subject to audit to major HUD programs. When testing compliance with specific requirements applicable/subject to audit for major programs, the auditor considers materiality in relation to each compliance requirement and each major program being tested.

In determining whether a compliance finding is material, the auditor should give consideration to both qualitative and quantitative factors.

Because the HUD audit guide and the Uniform Guidance require an opinion on *each* major HUD program, when considering whether instances of noncompliance are material to a major program the auditor considers the type and nature of the instances of noncompliance (either individually or aggregate), as well as the actual and projected impact of noncompliance, on each major program in which noncompliance was detected. For the purpose of expressing an opinion on major program compliance, the concept of materiality is applied to each major program as a whole, rather than to each individual compliance requirement. An amount that is material to one major program may be considered immaterial to another major program. If the tests of compliance reveal material noncompliance at the program level, the auditor should also consider the effect of that noncompliance on the financial statements. Noncompliance that is material to the particular type of compliance requirement for the HUD program and/or that meets the criteria in the HUD audit guide or the Uniform Guidance for being reported as an audit finding should be reported.

The authors recommend using the following guidelines when determining materiality at the major program level:

a. For Section 8 and other rent subsidy programs, materiality is generally considered to be 5% of total assistance expended.

b. For insured and coinsured loans, HUD-held mortgages, direct loans, capital advances, flexible subsidies, materiality is equal to the smaller of "tolerable misstatement" for purposes of financial statement materiality or 5% of the loan balance.

The authors believe that, in most situations, using 5% of total program awards expended will result in an appropriate materiality amount. However, other factors may impact this decision, and the auditor should use professional judgment in making this determination. Materiality for assessing compliance with a particular compliance requirement (compliance requirement materiality level) generally is less than major program level materiality to allow for the possibility of undetected noncompliance.

Planning Tests of Compliance. When planning tests of compliance, the materiality amount is one of the items that is used in making decisions about the nature, timing, and extent of procedures for individual HUD programs. The auditor frequently does not use a single source or single type of audit procedure to obtain sufficient appropriate audit evidence regarding each HUD program's compliance. Rather, the auditor's conclusions might be based on evidence obtained from several sources and by applying a variety of procedures (including those required by the HUD audit guide or those suggested by the OMB Compliance Supplement), such as analytical procedures, sampling, testing individually important items, or testing 100% of a population.

It is important to note that program and compliance requirement materiality would not be the auditor's sole consideration in making a decision about the type of audit procedure to be applied. The consideration of materiality should be combined with a careful consideration of audit risk, including the risk of material noncompliance, and other types of audit procedures in order to design the most efficient and effective audit approach, while also considering the requirements of the HUD audit guide and the Uniform Guidance.

Special Planning Considerations in HUD Audits

The authors believe that when a management agent is used, the auditors' consideration of audit risk should include specific consideration of the risk of material misstatement or noncompliance due to fraud by the management agent. When the personnel of a management agent are experiencing financial distress for business or personal reasons, there is an increased risk that they will misappropriate the project owner's assets. One common form of concealment of such misappropriations is to charge the amount of cash abstracted to the entity's expenses. If the entity's partners (or board members) do not monitor differences between the budget and actual expenses, the management agent may record fictitious expenses. In other cases, the management agent may not pay the project owner's legitimate expenses but record them as having been paid. Eventually the misappropriation will come to light when creditors bring legal action against the project owner, but that may take several months or years. (For example, litigation by a municipality for unpaid property taxes often takes years before coming to court.) If the auditor becomes aware of the presence of these or similar risk factors, he or she should consider them when identifying the risks of material misstatement or noncompliance due to fraud.

Misstatements resulting from fraudulent financial reporting (often referred to as management fraud) are intentional misstatements, or omissions, of amounts or disclosures from the financial statements with the intent of deceiving financial statement users. The effect of those misstatements causes the financial statements not to be presented, in all material respects, in conformity with GAAP. Examples that have been associated with HUD-assisted projects include:

- Overstating rental income and earnings to attract additional capital investment or for project marketability.
- Overstating rental income by a management company to increase the management fee or to earn higher bonuses.
- Overstating and understating earnings in individual projects under common management to conceal poorly performing projects.
- Overstating assets or understating liabilities to comply with debt covenants.
- Intentional noncompliance with the HUD Regulatory Agreement for the purpose of "equity skimming."

When considering the risk of misstatement or noncompliance caused by error, HUD entities may have risks in calculating tenant rental revenue. For example, in Section 236 projects, the owner calculates two rent payments for each tenant—one based on a mortgage that carries a market interest rate (referred to as the "market rent") and another based on a 1% mortgage (referred to as the "basic rent"). Each tenant is required to pay the higher of the basic rent or 30% of the tenant's adjusted gross income. The auditor needs to identify any specific risk that these areas might be misstated.

HUD entities may have accounting personnel who have limited accounting experience or training. Also, some entities might not have adequate accounting systems due to limited financial resources. These situations may impact the auditor's risk assessment.

In addition to the possibility of a management agent's intentional misstatement of the financial statements to deceive users, the auditor of a HUD entity needs to consider if management is under significant pressure to achieve unduly aggressive forecasts. For example, management might be committed to achieve certain results. Or there might be significant pressure to increase cash flow or report compliance with contractual or regulatory requirements.

Aspects related to employee theft can be complicated for any industry. If a HUD entity does not have adequate controls over cash receipts or property, theft can be a significant issue. It is important that the auditor understands the entity's controls over cash receipts or other assets that might be vulnerable to misappropriation.

Related party transactions are common for HUD entities. The auditor ought to consider whether the entity shares administrative expenses, staff, or premises with a related party. In each situation, it is important to have management identify the related party and for the auditor to verify that adequate segregation of assets is maintained and that appropriate disclosure is made, especially those that are also identity-of-interest transactions.

Establishing an Overall Audit Strategy

AU-C 300.07 states that the auditor should establish an overall strategy for the audit. The audit strategy is the auditor's operational approach to achieving the objectives of the audit. It is a high level determination of the audit approach, and it includes the identification of overall risks, overall responses to those risks, and the general approach to each audit area as being substantive procedures or a combination of substantive procedures and tests of controls. Determination of audit strategy would normally be determined by more senior and experienced members of the audit team, including the audit partner, given the judgments that are required. AU-C 300.08 provides that in establishing the overall audit strategy the auditor should do the following:

a. Determine the key characteristics of the engagement that define its scope.

b. Determine the reporting objectives of the engagement to plan the timing of the audit and the nature of communications required.

c. Consider the following:

   (1) Significant factors that will determine the focus of the engagement team's efforts.

   (2) Results of preliminary engagement activities.

   (3) If applicable, the knowledge from other engagements performed for the entity.

d. Determine the nature, timing, and extent of resources needed to perform the audit.

Steps a. and b. are relatively straightforward factual determinations of the information to be audited, reporting objectives, the overall timing of the audit, and the written and other communications that will be needed. Step c.(1) is the heart of determining the nature, timing, and extent of audit procedures that will be necessary. In establishing audit strategy, these matters are dealt with at a high level rather than at the detailed audit plan level, which describes the nature, timing, and extent of procedures at the relevant assertion level.

Important aspects of overall audit strategy that determine the focus of the audit team's efforts generally include the following:

- Materiality considerations, including:
  - Planning materiality.
  - Materiality for components and component auditors.
  - Preliminary identification of significant components and material classes of transactions, account balances, and disclosures.

- Preliminary identification of areas where there may be higher risks of material misstatement or noncompliance, including those due to fraud.
- Effect of assessed risks of material misstatement or noncompliance.
- Results of previous audits that involved tests of controls, including the nature of identified deficiencies and the action(s) taken to address them.
- Discussion of matters with firm personnel responsible for performing other engagements for the entity.
- Evidence of management's commitment to sound internal control and importance attached to internal control, including appropriate documentation.
- Volume of transactions.
- Significant changes in accounting standards.
- Evaluation by audit area of whether the auditor plans to obtain evidence regarding the operating effectiveness of internal control, i.e., whether the auditor plans to use substantive procedures alone or a combination of substantive procedures and tests of controls.
- Determination of the composition and deployment of the audit team (and if necessary, the engagement quality control reviewer), including the assignment of audit work to team members, especially the assignment of appropriately experienced team members to areas identified as having a higher risk of material misstatement.
- Manner of emphasizing the use of professional skepticism.
- Determination of general aspects of the nature, timing, and extent of further audit procedures, such as performing testing at the financial statement date rather than at an interim date.
- Identification of recent significant developments affecting the entity, its industry, its HUD programs, its financial reporting, or its legal or economic environment.
- Determination of areas where client assistance is expected to be minimal.
- Identification of the processes management uses to identify and prepare the disclosures, including those containing information obtained from outside of the general and subsidiary ledgers.

Determination of the type of financial statement misstatement can help the auditor determine the direction of the testing procedure. To illustrate this process for a HUD entity, consider how types of misstatements could affect the testing of rental revenue. If the auditor is concerned about the understatement of rental revenue, the focus of testwork may be on procedures such as examining documentation that is separately prepared and maintained outside of the accounting department and comparing that information to the rental revenue recorded in the financial statements. Such documentation could include lease agreements and contracts with HUD. However, if the auditor is concerned about overstatement of rental revenue, the focus of testwork may be on procedures such as confirmation of lease terms and accounts receivable with tenants.

Many HUD projects' operations are well suited to the application of analytical procedures. When considering the appropriateness of a predictive test for a HUD project without rent subsidies, the auditor might consider the example provided in Lesson 1. Additionally, the auditor could design a predictive test of security deposits using information from the rent roll and vacancy rates.

If suitable comparable data can be found, rent revenue and operating expenses can be expressed as an amount per unit or per square foot and compared to local multifamily operating data. Or, the auditor could review for unusual items revenue and operating expense by month as compared to prior periods and the budget.

As explained in Lesson 2, auditors are required to understand the design and implementation of internal controls and to document the understanding of the five components of internal control and the sources of information used and procedures performed to obtain that understanding, even if the audit strategy will be a primarily substantive approach. However, before deciding not to test controls in the financial audit, auditors need to be satisfied that performing only substantive procedures will be effective in reducing detection risk to an acceptable level. Information technology (IT) may affect an auditor's decision to adopt an audit strategy that is a primarily substantive approach.

Timing of Developing the Audit Strategy. In some cases, the auditor may have sufficient information to establish a preliminary audit strategy prior to performing extensive risk assessment procedures based on knowledge from past experience with the entity and the results of preliminary engagement activities. For example, in a continuing engagement, the auditor may be able to establish a preliminary audit strategy after completing the client continuance procedures based on knowledge from the previous engagements and discussions with the client regarding any new issues or changes in circumstances.

For new engagements, the auditor may have gained sufficient information while performing client acceptance procedures and gathering information for the fee proposal that would allow the development of a preliminary audit strategy. In fact, many auditors collect enough information during this process to make preliminary decisions on the assessment of overall risks, the determination of personnel requirements, use of specialists or component auditors, and other overall strategy matters. In these situations, the auditor simply needs to gather additional information throughout the performance of the risk assessment procedures to complete the overall audit strategy.

Overall Timing of the Engagement. Meeting the submission deadline for audits of HUD-assisted projects requires careful planning on the part of both the project owner and the auditor. The following items may be helpful in assisting project owners and auditors in meeting that deadline:

- Perform compliance and selected substantive procedures as of an interim date. Some compliance tests (such as tenant income certification verification), and substantive tests of low volume activity (such as asset additions and retirements), can be efficiently performed prior to year end.
- Confirm mortgage balances before year end, and audit the activity until year end.
- Confirm only material cash accounts, unless the risk assessment or the HUD audit guide prescribes otherwise.
- Include critical deadlines in the engagement letter.

In some cases, performing some audit work at an interim date is more efficient and effective for a HUD entity. Interim testing may allow the auditor to identify and resolve important issues early in the audit.

Revising the Initial Audit Strategy. It is not uncommon for auditors, after developing the initial audit strategy, to obtain information indicating that the audit strategy needs to be revised. AU-C 300.10 states that the auditor should update and modify the audit strategy as necessary throughout the engagement. Changes should be documented.

Communicating with Those Charged with Governance. The auditor may discuss elements of the overall audit strategy with those charged with governance. AU-C 260.11 requires the auditor to communicate with those charged with governance about the planned scope and timing of the audit, which includes communicating the significant risks identified by the auditor. This helps those charged with governance to perform their oversight duties with regard to the financial reporting process. When these discussions occur, the auditor should be careful not to compromise the effectiveness of the audit, for example, by discussing the detailed nature and timing of audit procedures.

Documentation. Establishing the overall audit strategy need not be complex or time consuming. The auditor can effectively establish the overall audit strategy through the completion of various steps in the general audit program provided in *PPC's Guide to HUD Audits*. However, AU-C 300.14 requires that the auditor document the overall audit strategy, the audit plan, and any significant changes made to them during the audit and the reasons. Professional standards do not necessarily require that a separate audit strategy memorandum be prepared to document, in one place, all matters that affect the audit strategy. Many of the matters that relate to the overall audit strategy would be documented in the normal course of gathering information about the entity and its environment.

An efficient approach to documenting the audit strategy, and any changes to it, in the audit of a small, noncomplex, nonpublic company is to prepare a brief memorandum at the conclusion of the previous audit, based on a review of audit documentation and highlighting issues identified in the audit just completed, and then update and change it in the current period to provide a basis for planning the current audit. The update can be based on discussions with the owner and/or management agent.

Documentation of Communications with Other Entities. The auditor might communicate with HUD field offices, HUD Office of Inspector General, grantor agencies or other federal or state auditors or other oversight entities to aid in planning the audit. The GAS/SA Audit Guide, Paragraph 3.16, suggests that as part of establishing the overall audit strategy, the auditor should document such communications and any decisions reached as a result.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

22. Planning decisions and judgments about which of the following affect the compliance portion of a HUD audit?

    a. Preliminary planning materiality.

    b. Program materiality.

    c. Overall audit strategy.

    d. Risk of material misstatement of the financial statements.

23. What is the correct term for the amount(s) set by the auditor at less than materiality for the financial statements as a whole to reduce the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole to an acceptably low level?

    a. Evaluation materiality.

    b. Performance materiality.

    c. Planning materiality.

    d. Tolerable misstatement.

24. What type of risk relates to the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before the auditor has considered any related controls?

    a. Audit risk.

    b. Control risk.

    c. Detection risk.

    d. Inherent risk.

25. Which of the following actions can help an auditor meet the deadline for a HUD audit in a timely manner?

    a. Perform compliance procedures after year end.

    b. Use mortgage balances confirmed at an interim date as final.

    c. Barring other issues, confirm only material cash accounts.

    d. Inform project owners of deadlines as they come due throughout the audit.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

22. Planning decisions and judgments about which of the following affect the compliance portion of a HUD audit? **(Page 382)**

    a. Preliminary planning materiality. [This answer is incorrect. Preliminary planning materiality (i.e., the materiality level for the financial statements taken as a whole) is one of the primary planning decisions and judgments for the financial statement audit, not the compliance audit.]

    b. **Program materiality. [This answer is correct. Additional planning decisions and judgments relative to the compliance portion of a HUD audit include (1) program materiality, (2) the risks of material noncompliance, and (3) the specific nature, timing, and extent of further compliance audit procedures.]**

    c. Overall audit strategy. [This answer is incorrect. The overall audit strategy is a collective group of judgments about the audit approach, including overall responses to risks. This is one of the primary planning decisions and judgments for the financial statement audit, not the compliance audit.]

    d. Risk of material misstatement of the financial statements. [This answer is incorrect. One of the primary planning decisions and judgments for the financial statement audit (not the compliance audit) is the risks of material misstatement at the financial statement level.]

23. What is the correct term for the amount(s) set by the auditor at less than materiality for the financial statements as a whole to reduce the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole to an acceptably low level? **(Page 384)**

    a. Evaluation materiality. [This answer is incorrect. This concept of materiality is used by the auditor when evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements. Evaluation materiality is one of the concepts of materiality that is rolled in with planning materiality.]

    b. **Performance materiality. [This answer is correct. This is the correct term for such amounts. AU-C 320.11 states that the auditor should determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing, and extent of further audit procedures.]**

    c. Planning materiality. [This answer is incorrect. According to AU-C 320.10, the auditor should determine a materiality level for the financial statements taken as a whole when establishing the overall strategy for the audit. The preliminary judgment about materiality at the financial statement level is generally referred to as *planning materiality*. The auditor uses this concept of materiality when planning and performing the audit.]

    d. Tolerable misstatement. [This answer is incorrect. As explained in AU-C 320.A3, *tolerable misstatement* is the application of performance materiality to a particular audit sampling procedure.]

24. What type of risk relates to the susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before the auditor has considered any related controls? **(Page 387)**

    a. Audit risk. [This answer is incorrect. In a financial statement audit, this is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement.]

b. Control risk. [This answer is incorrect. Per AU-C 200.14, this component of the risk of material misstatement is the risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.]

c. Detection risk. [This answer is incorrect. According to AU-C 200.14, this is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.]

d. **Inherent risk. [This answer is correct. This is the meaning of *inherent risk* as that term is defined in AU-C 200.14. Inherent risk and control risk together are the two components of the risk of material misstatement.]**

25. Which of the following actions can help an auditor meet the deadline for a HUD audit in a timely manner? **(Page 397)**

a. Perform compliance procedures after year end. [This answer is incorrect. To improve timing, auditors can perform compliance and selected substantive procedures as of an interim date. Some compliance tests (such as tenant income certification verification) and substantive tests of low volume activity (such as asset additions and retirements) can be efficiently performed *prior* to year end.]

b. Use mortgage balances confirmed at an interim date as final. [This answer is incorrect. When attempting to perform a HUD audit in a timely manner, the auditor may be well served by confirming mortgage balances before year end and then auditing the activity until year end. It would not be appropriate for the auditor to accept interim balances as final without further work.]

c. **Barring other issues, confirm only material cash accounts. [This answer is correct. Meeting the submission deadline for audits of HUD-assisted projects requires careful planning on the part of both the project owner and the auditor. One thing that may assist project owners and auditors in meeting the deadline is for the auditor to confirm only material cash accounts, unless the risk assessment or the HUD audit guide prescribes otherwise.]**

d. Inform project owners of deadlines as they come due throughout the audit. [This answer is incorrect. Including all critical deadlines to the project owner ahead of time in the engagement letter will help ensure the owner is aware of all due dates and provide adequate preparation time.]

CONSIDERATIONS FOR USING AUDIT SAMPLING

Introduction

Tests of account balances and transactions, tests of controls, and compliance tests in a HUD audit may be performed using observation, inquiry, or audit procedures applied to details. These audit procedures may or may not involve the use of sampling. This section focuses on sampling in the financial statement audit. A discussion of sampling in the compliance audit portion of a HUD audit is beyond the scope of this course, but more information is available in *PPC's Guide to HUD Audits*. The information in that *Guide* builds upon the general guidance about sampling discussed in this section and applies it for a compliance audit.

The authoritative guidance that applies when the auditor has decided to use audit sampling in performing audit procedures is provided in AU-C 530, *Audit Sampling*. AU-C 530 addresses the auditor's use of statistical and nonstatistical sampling when:

a. Designing and selecting the audit sample.

b. Performing tests of controls and tests of details.

c. Evaluating the results of the sample.

The AICPA has also issued the Audit Guide, *Audit Sampling* (referred to in this course as the AICPA Sampling Guide), which is an interpretive publication. The AICPA Sampling Guide provides interpretive guidance to apply the concepts in AU-C 530, including its definitions.

Audit Sampling. Audit sampling is the selection and evaluation of less than 100% of a population such that the auditor can reasonably expect the items in the sample to be representative of the population and likely to provide the auditor with a reasonable basis for conclusions about the population. That is, evaluation of the sample would likely result in similar conclusions as would be drawn for tests applied to the entire population. The following situations generally do *not* involve audit sampling:

a. Application of an audit procedure limited to a specific group of items within a balance or class of transactions that have a distinct characteristic, e.g., all property and equipment additions over $5,000.

b. Examining a few transactions within a balance or class of transactions to obtain an understanding of the nature of the client's operations.

c. Applying audit procedures to one or a few transactions of each type to clarify the auditor's understanding of the design of the company's internal controls.

In each of these three examples, the auditor is not selecting items expected to be representative of the population to provide a reasonable basis for drawing conclusions about the population from which the items were selected. In item a, the auditor is dividing the account balance or transaction class into two populations and selecting 100% of one of those populations. In items b and c, the auditor is selecting items to obtain information that will increase the auditor's understanding rather than attempting to reach a conclusion about a population of items. In each of these cases, authoritative pronouncements on sampling would not apply to the test performed. When the auditor reaches a conclusion about some aspect of an entire account balance or transaction class on the basis of examining less than 100% of the population, the auditor has to follow the requirements of AU-C 530.

Tolerable Misstatement. AU-C 530.05 explains that *tolerable misstatement* is an amount the auditor sets to obtain an appropriate level of assurance that the amount will be less than the actual misstatement in the population. AU-C 530.A6 explains that tolerable misstatement is the application of performance materiality to a particular sampling procedure. AU-C 530.A6 also provides the guidance that tolerable misstatement may be the same amount or an amount smaller than performance materiality. The AICPA Sampling Guide (paragraph 4.52) explains that auditors may consider tolerable misstatement as an extension of the concept of performance materiality applied at the test level to accounts, balances, or classes of transactions. In other words, performance materiality is materiality at the account balance or class of transactions level. Tolerable misstatement is materiality at the test or procedure level, for a specific account balance or transaction class, when that procedure or test is applied using audit sampling.

Statistical Sampling. Despite the fact that there has been authoritative audit guidance on audit sampling for nearly four decades, confusion persists concerning the distinction between the concepts of statistical sampling and audit sampling. Audit sampling does not equate to statistical sampling. Audit sampling can be either statistical sampling or nonstatistical sampling. The requirements of AU-C 530 apply whether the approach to audit sampling is statistical or nonstatistical. AU-C 530.05 explains that *statistical sampling* has the following characteristics:

a. Random selection of the sample items.

b. Use of an appropriate statistical technique to evaluate sample results, including measuring sampling risk.

A sampling approach that does not have *both* of those characteristics is considered nonstatistical sampling. Thus, even if the auditor uses a random selection method in drawing sample items, the approach is still considered nonstatistical if the auditor does not use a statistical technique to evaluate the sample results. Nonstatistical sampling does not allow the numerical measurement of sampling risk.

Basis for the PPC Approach to Audit Sampling. The approach to audit sampling is nonstatistical because a statistical technique is not used to evaluate sample results. The approach uses the statistical model of Monetary Unit Sampling (MUS), to compute sample size, but various approximations are used to consider sampling risk in the planning and evaluation of samples. As a result, the approach is considered to be nonstatistical. The approach also emphasizes consideration of whether selecting all items or high dollar and significant items would be more efficient and effective than using audit sampling.

Uses of Audit Sampling

In a HUD engagement, three distinct types of audit procedures may involve the use of audit sampling as follows:

a. Substantive tests of details of account balances.

b. Substantive tests of details of transactions.

c. Tests of controls directed toward operating effectiveness.

The auditor may also perform a dual-purpose test that applies both tests of details and tests of controls (b and c) to the same sample of items.

Substantive Tests of Account Balances. The auditor's objective in using a substantive test of an account balance is to decide whether the balance is materially misstated. Audit sampling is usually necessary in applying a substantive test of an account balance when the balance is composed of a large number of items and the remaining balance, after identifying individually significant items, exceeds tolerable misstatement. A common audit sampling application for a substantive test of an account balance is confirmation of accounts receivable.

Substantive Tests of Transactions. The auditor's objective in using a substantive test of transactions is to decide whether the total of a transaction class is materially misstated. The auditor inspects documents supporting recorded transactions to determine whether transactions are valid, and valued and coded properly, i.e., recorded correctly as to account, amount, and period. Tests of transactions are often unnecessary in nonpublic company audits if the income statement does not present unnecessary detail or if alternatives such as effective analytical procedures can be applied to transaction classes. However, in some engagements, this type of test may be a common audit sampling application. It can be used for testing most types of expenditures, e.g., payroll, expenditures for goods and services, etc.

PPC's Guide to Audits of Nonpublic Companies explains a practical nonstatistical sampling approach that can be used in a HUD audit for tests of details using audit sampling, as well as an approach to avoid the use of sampling by determining the extent of testing using individually significant amounts.

Designing Tests of Transactions Using Audit Sampling

AU-C 530 establishes requirements for the planning, selection, performance, and evaluation of sampling in tests of transactions. The authors have developed an efficient nonstatistical sampling approach that meets these requirements and approximates a statistical attribute sampling method sometimes referred to as "stop-or-go" (or sequential) sampling.

Planning. Two basic conditions for using this approach are (a) that the audit procedure being applied using sampling is not the only procedure that contributes to the objective of the test and (b) a relatively low rate of processing mistakes is expected. These conditions are intended to compensate for the fact that judgments about sample size and sample results using this approach are approximations rather than exact statistical computations. Normally, using this approach, the auditor need only make a choice between a sample size of 60 and a sample size of 25. A sample of 25 with no misstatements or deviations would approximate an upper limit on the rate of misstatement of 10% and allowable sampling risk of 10%. A sample of 60 with no misstatements or deviations would approximate an upper limit rate of 5% and a sampling risk of 5%.

The basic condition that there be other audit procedures that contribute to the same objective as the procedure being applied using sampling is normally satisfied by performing analytical procedures.

The condition that permits a sample of 25 rather than 60 is that, based on the auditor's understanding of internal control, there are controls that are pertinent to the aspects of transaction processing being tested that appear to be effective and that are being tested simultaneously.

Sample Selection. AU-C 530.08 requires a representative sample for audit sampling applications. The AICPA Sampling Guide (Paragraph 1.05) explains that a representative sample is free from selection bias. At Paragraph 3.29, it further explains that to be representative, all items in the population need to have an opportunity to be selected. There are several commonly used methods of selecting representative samples. Among the methods that meet this requirement are simple random selection using random numbers, systematic selection (every *n*th item), or haphazard selection. The first two methods are explained in detail in sampling textbooks and described in the AICPA Sampling Guide. The concept of haphazard selection is explained in the AICPA Sampling Guide as selecting in no specific pattern without conscious bias for including or omitting any items in the population. In other words, to achieve haphazard selection, the auditor's selection should not be influenced by the size, location, or appearance of the item.

The auditor might consider using simple random selection (with computer-generated random numbers or a random number table) or systematic selection with several random starts. Using these approaches does not make the audit sampling application a statistical sample. Haphazard selection may be used when the population is not numbered or when other circumstances make use of one of the other methods impractical. The authors recommend using computer-generated random numbers because it is more efficient than using a table.

Evaluation. The evaluation of sample results for the transaction testing approach differs for a sample size of 25 versus a size of 60. The sample size of 25 is used when the auditor is simultaneously testing internal controls that help ensure accounting accuracy. The auditor identifies and tests only those controls that are pertinent to these matters and that would make a difference to the auditor's control risk assessment. To support an assessment of control risk below the maximum, the sample results for a sample of 25 should contain no deviations from the identified controls. In qualitative terms, no deviations in a sample of 25 may be interpreted as a moderate level of control risk. For this reason and for reasons of efficiency, the auditor should not identify and test control activities that would not change the control risk assessment, and any deviations from unimportant controls that turn up in sample results should be ignored. Generally, a mistake in accounting processing, that is, recording in the wrong account, amount, or period, should be treated in the same manner as a deviation from internal controls. The reason for this is that a misstatement can usually be traced to a deficiency in the system. However, it is always important to make a qualitative analysis of the nature and cause of the misstatement. The auditor needs a good understanding of the cause of the misstatement to consider what steps should be taken to help ensure that there is not an unacceptable risk that similar misstatements could accumulate to a material amount. In the rare case when a misstatement is an isolated instance and there are no indications of a deficiency in controls, the auditor need not change the control risk assessment. However, most misstatements are not isolated incidents, and the auditor should make this judgment carefully. For example, a keying error not detected by the system is a deficiency in the system and not an isolated incident simply because it occurred randomly.

When the auditor has initially selected a sample of 25 and sample results include one deviation from controls that are important to the control risk assessment, the sample size for the test should be expanded to 60. The reason for this is that a sample size as small as 25 to assess accounting accuracy is only appropriate when control risk can be assessed below the maximum level. When sample results do not support a control risk assessment below the maximum, expanded testing of accounting accuracy is necessary.

When the auditor has initially selected a sample of 60 or expanded the sample size to 60, the focus of the evaluation shifts primarily to a qualitative analysis of the nature and cause of any misstatements detected. Based on the understanding obtained of why the misstatements occurred, the auditor assesses whether there is an unacceptable risk of similar misstatements accumulating to a material amount. This type of analysis requires a good understanding of the client and its industry and internal control. No quantitative analysis can substitute for a seasoned qualitative assessment of the nature and cause of misstatement and the steps that need to be taken in the particular case to detect additional misstatements if they exist. According to AU-C 450.07, if the auditor considers the amount of projected misstatement from a sample in a class of transactions to be material, either individually or in the aggregate with other misstatements, the auditor should request management to examine the class of transactions to identify and correct misstatements therein.

Documentation of Transaction Testing

The decisions and sample results for transaction testing using audit sampling should be documented.

THE ORGANIZATION AND STRUCTURE OF DETAILED AUDIT PLANS AND WORKPAPERS

Overall Aspects of Audit Programs

AU-C 300, *Planning an Audit*, at AU-C 300.09, states that the auditor should develop an audit plan that includes a description of (a) the nature and extent of planned risk assessment procedures, (b) the nature, timing, and extent of planned further procedures at the relevant assertion level, and (c) other planned procedures that are required to be carried out so that the engagement complies with GAAS. The audit plan is more detailed than the audit strategy and includes a detailed description of audit procedures to be performed by engagement team members in order to obtain sufficient appropriate audit evidence to reduce audit risk to an acceptably low level.

As part of developing the overall audit strategy, the auditor will ordinarily have identified programs, locations (or components), account balances, and audit areas where there may be higher risks of material misstatement or noncompliance. Once the audit strategy has been established, the auditor is able to start the development of a more detailed audit plan to address the various matters identified in the audit strategy, taking into account the need to achieve the audit objectives through the efficient use of the auditor's resources. The audit plan is commonly referred to as the audit program.

Assertions. In forming an opinion on the financial statements and performing procedures related to HUD program compliance, the auditor obtains and evaluates evidence about the assertions made by management. AU-C 315A.04 explains that *assertions* are management's representations in the financial statements, whether or not explicit, that the auditor uses to consider the types of potential misstatements that might occur. AU-C 315A.A133 explains that assertions used by the auditor fall into the following categories:

- Assertions about classes of transactions and events, and related disclosures, for the period under audit.
- Assertions about account balances, and related disclosures, at period end.

When designing an audit program, the auditor needs to obtain evidence to support relevant assertions. Thus, the auditor designs and performs substantive procedures for all assertions relevant to the financial statements and to the compliance requirements for each major HUD program.

Auditing standards give prominent recognition to the idea of relevant assertions. Relevant assertions are identified by evaluating the following:

- The source of likely potential misstatement or noncompliance.
- The nature of the assertion.
- The volume of transactions or data related to the assertion.
- The nature and complexity of the systems, including the use of IT, by which the entity processes and controls information supporting the assertion.

Audit Objectives. An audit objective is, in effect, an assertion translated into terms relevant to a specific account or HUD program. When the assertions are restated in specific terms for an account or program, they become audit objectives for an auditor to achieve in designing an audit program.

Audit Procedures. The basic requirement for selection of audit procedures is that the auditor should obtain audit evidence to draw reasonable conclusions on which to base the audit opinion by performing audit procedures to—

a. obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels (i.e., risk assessment procedures);

b. when applicable, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertion level (i.e., tests of controls); and

c. detect material misstatements at the relevant assertion level (audit procedures performed for this purpose are referred to as substantive procedures and include tests of details of classes of transactions, account balances, and disclosures, and substantive analytical procedures).

Risk assessment procedures by themselves do not provide sufficient appropriate audit evidence on which to base the audit opinion. Auditors must supplement risk assessment procedures with further audit procedures in the form of tests of controls, when relevant or necessary, and substantive procedures.

Paragraph 10.41 of the GAS/SA Audit Guide, explains that in a compliance audit, the auditor must perform tests of transactions and other such auditing procedures necessary to provide the auditor sufficient appropriate audit evidence to support an opinion on compliance for each major program. In a HUD audit, this requires designing procedures to detect both intentional and unintentional noncompliance. It is important to remember that procedures that are effective for detecting unintentional noncompliance may not be effective for detecting noncompliance that is intentional and concealed through collusion between the auditee's personnel and a third party or among the management or other employees of the entity.

Determining the Audit Approach for the Financial Statement Audit

Based on the assessments of the risks of material misstatement at the relevant assertion level, the auditor determines what further audit procedures need to be performed. For simplicity in the discussions throughout this course, the authors refer to the decisions of which further audit procedures will be performed as the selection of an audit "approach." In this course, the approach selected by the auditor to respond to the risk assessment and documented for relevant assertions within each audit area involves the following decisions—

- Performing only limited procedures and not developing a separate audit program.
- Performing basic procedures from the core audit program, or performing basic procedures plus certain extended procedures from the core audit program.

The following paragraphs include initial considerations involved in choosing the appropriate audit approach and using the chosen approach. The authors anticipate that auditors will tailor the audit programs for individual audit areas to respond to their client's specific risks and circumstances.

Performing Only Limited Procedures. The auditor first considers whether the preliminary analytical procedures and other risk assessment procedures performed during initial planning and the final analytical procedures performed in the overall review stage of the audit provide enough assurance that no further audit procedures are considered necessary. In other words, no separate specific audit program is needed for the audit area because the procedures for performing preliminary analytics, other risk assessment procedures, and final analytics are included in the general programs. That approach is referred to as the Limited Procedures approach and will be appropriate only for financial statement audit areas that are not significant. In some cases an auditor might decide that analytical procedures alone provide sufficient evidence for a financial statements audit of a HUD entity.

In some cases, REAC requirements, the HUD audit guide, other HUD handbooks, or the OMB Compliance Supplement may require or suggest certain substantive audit procedures to be performed. For example, according to the HUD Handbook 4370.2 confirmation of security deposit accounts is required. In addition, for significant audit areas, the auditor is required to perform some substantive procedures for each relevant assertion; therefore, an audit program is always needed for those areas.

Basic and Extended Approaches. The audit programs in *PPC's Guide to HUD Audits* include both general audit programs and audit programs for specific financial statement audit areas. To assist auditors in tailoring their audit procedures to appropriately respond to the risk assessment, the core audit programs for individual audit areas include the following sections:

- *Basic Procedures*, which include a combination of substantive analytical procedures and tests of details.
- *Extended Procedures (Procedures for Additional Assurance)*, which include procedures from which the auditor can choose or develop one or more steps as necessary to supplement the basic procedures in response to the auditor's risk assessment at the relevant assertion level.
- *Other Audit Procedures*, which include procedures that may be warranted due to the specific circumstances of the engagement. (Other Audit Procedures are considered Extended Procedures when completing the "Risk Assessment Summary Form.")

Auditors using those audit programs decide whether to apply basic or basic plus extended procedures based on the risk assessment at the relevant assertion level. This analysis is not a simple determination based on whether risk is high, moderate, or low. A low or moderate risk of material misstatement for an assertion indicates that a Basic Procedures approach may be appropriate for that assertion. The auditor also has to consider the expected cause and direction of potential misstatements, the relationships among audit areas, and whether the risks are fraud risks or other significant risks. The particular tests selected, whether they are in the Basic or Extended section of the audit programs, should be tailored to the nature, cause, and direction of potential misstatements at the relevant assertion level. It may also be appropriate to modify the extent or timing of the procedures to adequately respond to the risk assessment. If an audit area includes one or more significant risks, basic procedures will have to be modified or extended procedures added.

Documenting the Approach Selected. The approach that the auditor has selected should be documented. Comments that may be appropriate concerning the audit program, including the linkage between risks and responses, may also be included. Of particular importance is the explanation of how the planned procedures are responsive to the specific assessed risks of material misstatement at the relevant assertion level. For significant risks (both fraud and other risks), an auditor may decide to prepare a separate memo that documents the manner in which the selected approach and procedures are responsive to the assessed risks of material misstatement.

Compliance Audit Programs

The HUD audit guide and the OMB Compliance Supplement contain suggested audit procedures for testing compliance. The auditor should use professional judgment in determining the audit procedures to be performed to obtain sufficient appropriate audit evidence to form an opinion on compliance.

Audit Documentation

AU-C 230, *Audit Documentation*, addresses the auditor's responsibilities for audit documentation for an audit of financial statements. It requires the auditor to prepare and retain workpapers; addresses the form, content, and extent of audit documentation; and specifies requirements for revisions made to documentation after the date of the auditor's report. GAO *Government Auditing Standards, 2018 Revision Technical Update April 2021* (the Yellow Book) establishes documentation requirements that are in addition to GAAS requirements. Yellow Book documentation requirements are discussed where relevant in this course. (Throughout this course, the authors use the terms *audit documentation* and *workpapers* interchangeably. The term *workpapers* is still widely used in practice, and the authors continue to use that term to describe all recording media whether paper, electronic, or other.) The main purpose of workpapers is to provide the principal evidence for the auditor's report that includes:

- The representation that the audit was performed in accordance with generally accepted auditing standards (and, if applicable, other auditing standards, such as *Government Auditing Standards*).
- The auditor's opinion(s).

Support for Auditor's Report. Auditors should prepare audit documentation with an appropriate amount of detail that provides a clear understanding of the work performed, the evidence obtained along with its source, and the conclusions reached. One critical need to use workpapers to support the audit report arises if the quality of the audit is questioned, for example, in litigation or regulatory proceedings where an auditor has to defend the quality of the audit. Audit documentation is an essential aspect of audit quality. An auditor's defense, however, may not be entirely limited to what is in the workpapers. The workpapers are the principal record of the work done and conclusions reached, but an auditor, in defending the quality of the audit, might supplement the audit documentation by other means. Oral explanations may be used to explain or clarify information in the audit documentation; however, AU-C 230.A7 explains that oral explanations alone are not adequate support for the work performed or conclusions reached.

While an auditor will not document every consideration made during the course of the audit, care needs to be taken to ensure that the audit documentation meets the overall requirement of providing a clear understanding of the work that was done, the evidence gathered, and conclusions that were reached based on the procedures and evidence obtained. As noted above, the possible use of oral explanations is not a substitute for sufficient, appropriate audit documentation that supports the auditor's report.

Basic Requirements for Content. Both AICPA standards and *Government Auditing Standards* establish audit documentation requirements that should be considered when planning an audit. The basic requirements for workpaper content in authoritative pronouncements allow some discretion in deciding on the specific workpapers to prepare, but AU-C 230 provides the key criterion auditors can use in making documentation decisions. Workpapers should enable *an experienced auditor with no previous connection to the audit* to understand—

a. The nature, timing, and extent of auditing procedures that were performed to comply with GAAS, *Government Auditing Standards*, and other applicable standards and requirements, such as the requirements of the HUD audit guide or the Uniform Guidance.

b. The results of the audit procedures performed and the audit evidence obtained.

c. Significant findings or issues that arose during the audit.

d. The conclusions reached and significant professional judgments made in reaching them.

This criterion is sometimes referred to as a "reviewability" requirement. The use of the term *experienced auditor with no previous connection to the audit* reinforces a documentation concept practiced by many auditors that workpapers need to "stand by themselves" and need little or no oral explanation as to what was done, who performed the work, and the reasons for the conclusions reached. AU-C 230.06 considers an experienced auditor to be an individual with practical audit experience and the necessary competence and skill to perform the audit, including an adequate knowledge of professional standards and applicable legal or regulatory requirements, the audit process, the client's business environment, and the audit and financial reporting issues that apply to the client's industry.

The requirement for reviewability by an experienced auditor *with no previous connection to the audit* means that evaluating the adequacy of the audit work performed by inspecting the documentation of that work should not require knowledge of matters known to the audit team, but not recorded in the workpapers.

Audit documentation for financial audits performed under the Yellow Book should contain the following additional items not explicitly addressed in the AICPA standards or elsewhere in the Yellow Book:

a. If the auditor judges it necessary to depart from a relevant presumptively mandatory requirement, the auditor must document the justification for the departure and how alternative procedures were sufficient to achieve the intent of the requirement. The Yellow Book, Paragraph 2.19, states that when an auditor does not comply with *Government Auditing Standards* requirements, the auditor should (1) assess the significance of the noncompliance, (2) document that assessment and the reasons for not complying, and (3) determine the type of *Government Auditing Standards* compliance statement.

b. Supervisory review of the evidence that supports the auditor's report before the report release date.

AU-C 230.09–.15 provide certain specific audit documentation requirements as follows:

a. Audit documentation should include copies of the client's records and abstracts or copies of significant contracts or agreements examined.

b. Documentation of procedures performed should identify the items tested.

c. When documenting the audit procedures performed, auditors should record who performed the work, the date of completion, who reviewed specific documentation, and the date and extent of the review.

d. Auditors are required to document information related to significant audit findings or issues.

e. In the rare instances where an auditor deems it necessary to depart from a presumptively mandatory requirement, documentation must be made of the justification for the departure and how alternative procedures performed were sufficient to achieve the objectives of the requirement.

f. Auditors are required to document certain items if revisions to the workpapers are necessary after the date of the auditor's report.

g. The report release date should be recorded in the audit documentation.

Documenting Specific Items Tested and Other Procedures. Audit documentation of the procedures performed should include identifying characteristics of the specific items that were tested. This requirement includes tests of the operating effectiveness of controls, substantive tests of details involving inspection of documents or confirmation, and inquiry and observation procedures. For inspection of documents and confirmation procedures, the authors believe items tested can be identified by listing the items; by including a detail schedule in the workpapers, such as an aged trial balance, on which the items are identified; or by documenting in the workpapers the source and selection criteria. For example:

- For tests of significant items, documentation may describe the auditor's scope and the source of the items (for example, all disbursements greater than $5,000 from the December cash disbursements records).

- For haphazard or random samples, documentation may identify the items by their dates and specific check numbers, employee numbers, etc.

- For systematic samples, documentation may indicate the source, starting point, and sampling interval (for example, a selection of checks from the cash disbursements journal for the period 1/1/X2 to 12/31/X2, starting with check number 2150 and selecting every 100th check thereafter).

For inquiry and observation procedures, the identifying characteristics may be recorded as follows:

- For inquiries, document the dates of the inquiries, the names and job functions of client personnel queried, and the inquiry that was made.

- For observations, document the matter observed, the individuals involved and their responsibilities, and where and when the observation took place.

If an analytical procedure is used as a substantive procedure for a relevant financial statement assertion, AU-C 520.08 requires the auditor to document (a) the expectation and the factors considered in its development (unless readily determinable from the work performed), (b) the results of the comparison between the expectation and recorded amounts, and (c) any additional procedures performed to address significant unexplained differences and the results of those procedures. Although not required by authoritative literature, documentation might also include information about the auditor's approach to evaluating the significance of the difference between the recorded amount and the expectation.

<u>Documenting the Identification of Preparer and Reviewer.</u> According to AU-C 230.09, auditors should record who performed the audit procedures and when the work was completed. In most situations, this is a simple process; typically the individual who performed the procedure initials and dates the specific workpaper, checklist, or program step that specifies the work performed.

AU-C 230.09 also requires documentation of who reviewed *specific* audit documentation and the *date* of the review. AU-C 230.09 does not indicate the manner or form of recording the evidence of these "who and when" components of the review. However, reviewers are *not* required to evidence their review on each working paper. For detailed reviewers, a practical and efficient way of indicating who reviewed the audit work and when is for the reviewer to initial and date the specific workpapers reviewed. However, auditors may adopt other documentation methods to evidence this review as long as it is clear who reviewed specified elements of the work and when the review occurred. Some auditors, especially those performing the partner level review, may prefer documenting the evidence of their review in a memo that indicates the workpaper sections reviewed and the date(s) of their review. Checklists may also be used.

Government Auditing Standards establishes an additional requirement that relates to supervisory review. Paragraph 6.31 of the Yellow Book indicates that auditors should document supervisory review of the evidence that supports the auditor's report before the report release date.

<u>Documenting Significant Findings or Issues.</u> AU-C 230.08 requires auditors to document significant findings or issues during the audit, actions taken, evidence obtained in addressing them, and significant professional judgments made in reaching conclusions. In particular, the documentation of significant professional judgments serves to explain conclusions and reinforce the quality of the judgments, which may be especially valuable to reviewers and to users of the workpapers in subsequent years (for example, when performing a retrospective review of accounting estimates).

Communication of key audit matters (KAMs), is not required in audits of nonissuers, unless the auditor is engaged to report KAMs. If an auditor is engaged to report on KAMs, the situations when it is appropriate to prepare audit documentation related to the exercise of significant professional judgment will be expanded to include (a) determining KAMs; (b) determining there are no KAMs; and (c) documenting a KAM is not reported because the adverse consequence of reporting is reasonably expected to outweigh the public interest benefits.

Discussions of significant findings or issues that occur between the auditor and management should be documented in a timely manner, including the items discussed, and when and with whom they were discussed. In addition, the auditor should document similar information regarding any discussions of significant findings or issues with internal or external parties other than management. That may include those changed with governance, lower level employees, or professional service providers. Minutes of meetings attended by the auditor at which these matters were discussed can provide this documentation.

Auditors should also document how they addressed information that was contradictory or inconsistent with their final conclusion on a significant finding or issue. Such documentation might include the auditor's procedures to address the information or consultations regarding, or resolutions of, differences in professional judgment among audit team members or between the team and others consulted. This documentation requirement does not necessitate retaining information that is incorrect or superseded unless it is identified after the documentation completion date as discussed later in this section.

Significant findings or issues may be documented in a separate memorandum. The authors recommend that such a memorandum begin with a description of the facts giving rise to the issue, followed with a discussion of the factors considered and evidence gathered in formulating the conclusion. The auditor's conclusion ought to be clearly stated, along with the reasoning process supporting the conclusion. Other items that ought to be documented include any discussions of significant findings or issues, as noted above; the existence of conflicting evidence or guidance supporting contrary points of view; and any consultation that occurred in resolving the issue.

Finally, SQCS No. 8 requires firms to adopt quality control policies and procedures regarding professional consultation and differences of opinion. Consultations may involve complex, unusual, unfamiliar, difficult, or contentious issues (such as the significant findings or issues previously discussed) and may involve professionals within or outside the firm. Differences of opinion may arise within the engagement team, with individuals consulted, or between the engagement partner and the engagement quality control reviewer. SQCS No. 8 provides for documentation of consultations and differences of opinion.

Assembling, Completing, and Making Changes to Audit Documentation. Timely completion of audit documentation is critical to assure audit quality. As a practical matter, the auditor ought to strive to prepare audit documentation as the audit progresses to avoid inadvertently omitting critical information or incorrectly recording aspects of the procedures that were completed or the evidence obtained. When concluding the audit, the auditor ought to ensure that the documentation meets the objectives mentioned in the "Audit Documentation" discussion earlier in this section. Professional standards also include requirements for (a) assembling and completing the workpapers at the conclusion of the audit and (b) making revisions to the documentation after the date of the auditor's report. These requirements are centered on the following key dates:

- The audit report date.
- The report release date.
- The documentation completion date.

Those dates, as well as the requirements for assembling and completing the audit file and making changes to the workpapers, are discussed in the following paragraphs.

The *audit report date* represents the date that the auditor has obtained sufficient appropriate audit evidence to support his or her opinion on the financial statements. The same requirement applies to dating the auditor's reports on internal control over financial reporting, compliance, and the schedule of expenditures of federal awards, as applicable. Typically, such evidence includes evidence that:

- The audit work has been reviewed.
- The financial statements, including disclosures, have been prepared.
- Management has taken responsibility for the financial statements, supplementary information, and the schedule of expenditures of federal awards (if applicable).

The auditor cannot simply use the date that the audit team left the field unless the requirements of this paragraph have been satisfied at that date.

AU-C 220A.19 requires that by the date of the audit report, the engagement partner be satisfied that sufficient appropriate evidence has been obtained to support audit conclusions and the audit report to be issued, by discussion with the engagement team and a review of audit documentation. The authors believe that it is implicit in this requirement that detailed and supervisory reviews need to be completed before the engagement partner's review. AU-C 220A.A17 observes that the engagement partner may review all audit documentation but need not do so. AU-C 230.09c requires documentation of who reviewed the audit work and the review's date and extent.

The *report release date* is the date that the auditor gives the client permission to use the auditor's reports. For most HUD audits, this will be the date the auditor delivers the report to the client. AU-C 230.15 requires the auditor to document the report release date in the workpapers. In most cases, the report release date will be close to the date of the auditor's report. Many firms adopt a policy about when to date their auditor's report if there is a delay in releasing the report (that is, how long of a delay makes it necessary to redate the report). If there are significant delays in releasing the report, auditors ought to consider the need to apply guidance related to subsequent events. The authors believe that a delay in releasing the report of more than two weeks after the report date ought to result in extending the subsequent events review to the later date and redating the report. This matter may be covered in the firm's quality control policies and procedures.

SQCS No. 8 (QM 10A.49) requires firms to establish policies and procedures that require final engagement files to be assembled on a timely basis after the reports have been released. Those policies and procedures need to comply with any time limits established by professional standards, laws, or regulations that address the assembly of final engagement files for specific types of engagements. Professional standards require completing workpapers on a timely basis. However, the final assembly and completion of the audit file should occur within 60 days of the report release date. AU-C 230.06 refers to the date that workpapers should be completed as the *documentation completion date*. After that date, the auditor *should not* delete or discard any documentation prior to the expiration of the required five-year retention period indicated by AU-C 230.17. Auditors may adopt documentation completion periods that are shorter than 60 days, either on an engagement-by-engagement basis, or as part of the firm's system of quality control. In addition, the auditor needs to consider whether there are regulatory or state requirements that require a shorter documentation completion period.

While AU-C 230 does not specifically require the auditor to document the required documentation completion date, as a practical matter documentation of that date will ensure compliance with the requirement to complete final assembly of the workpapers within 60 days of the report release date.

At any time prior to the documentation completion date, the auditor is permitted to make changes to the workpapers that are administrative in nature to:

- Finalize the documentation and assemble the evidence that was obtained, discussed, and agreed among the audit team prior to the date of the auditor's report, including discarding to-do lists and superseded drafts, correcting typographical errors, and changing notes that reflect incomplete or preliminary thinking.
- Insert information that was received after the date of the auditor's report such as replacing faxed copies of confirmations with originals.
- Perform routine file assembly procedures that might include sorting, cross-referencing, collating, and deleting or discarding superseded documentation.
- Sign off on file completion checklists prior to completing and archiving the workpapers.

The examples provided in this paragraph emphasize that changes to the workpapers after the date of the auditor's report and prior to the documentation completion date constitute those that are part of the "wrap-up" or workpaper filing process. The auditor should not make changes after the report date that would have impacted the documentation of the work performed, the evidence obtained, the conclusions reached, or the review that was conducted prior to that date.

AU-C 230.14 provides requirements for audit documentation when the auditor determines that it is necessary to make additions or other changes to the audit workpapers after the date of the auditor's report other than those activities noted in the previous paragraph. Such changes may relate to the following:

a. *Omitted Procedures That Would Have Been Considered Necessary at the Time of the Audit.* In such cases, auditors should follow the guidance provided by AU-C 585, *Consideration of Omitted Procedures After the Report Release Date*.

b. *Subsequent Discovery of Facts That Existed at the Date of the Report.* For situations in which the auditor subsequently becomes aware of information that existed at the date of the report but was not previously known to the auditor, the provisions of AU-C Section 560, *Subsequent Events and Subsequently Discovered Facts*, should be followed.

For those changes, the auditor should make changes to the audit documentation to record the new procedure or the new conclusions that were reached. The documentation of the changes should include:

- When and by whom the changes were made and, if applicable, reviewed.
- The specific reasons for the change.
- The procedures performed, audit evidence obtained, conclusions reached, and the effects, if any, on the auditor's report.

The auditor should also consider whether there are regulatory or state requirements that differ from GAAS, such as Yellow Book requirements or those of a state agency that provides grant funding.

Audit Documentation Requirements. HUD auditors must meet the documentation requirements of GAAS and GAGAS, as well as the engagement-related requirements of SQMS No. 1. There may be additional documentation requirements under the AICPA *Code of Professional Conduct* and specified by regulatory agencies, such as state regulators.

Access to Audit Documentation. When an entity expends federal awards, such as from HUD programs, audit staffs of grantor agencies like HUD are permitted access to the auditor's workpapers, and additional documentation may be necessary to meet GAO standards. Paragraph 1-5(A)(3) of the HUD audit guide requires the auditor to provide the HUD Secretary or his or her designee, the HUD OIG, and the GAO (or their representatives) access to hard copy or electronic audit documentation or any other documents needed to review the audit. Access includes making any necessary photocopies of hard copy documentation or other documents, or electronic copies of electronic audit documentation. In addition, both the Uniform Guidance and the Single Audit Act Amendments of 1996 require the auditor to make audit workpapers available for review by regulators and to allow regulators to obtain copies of the workpapers.

Common Documentation Deficiencies. The GAO and HUD continue to express concerns about the quality of HUD audits. These concerns are highlighted by the continuation of the quality reviews of auditors through the QASS as discussed in Lesson 1. A common deficiency in the engagements is inadequate audit documentation. Similarly, of the following audit deficiencies noted by HUD many relate to documentation problems:

- Pre-engagement Considerations and Planning:
  - Licensing requirements not met or not documented.
  - Failure to document the audit plan or the audit program in the workpapers.
  - Lack of documentation of determination of major programs.
  - Inadequate documentation of internal control.
  - Inadequate documentation of preliminary analytical review.
  - Insufficient follow-up procedures from prior-year audits.
- Field Work:
  - Failure to document tests of compliance.
  - Failure to comply with GAAS (AU-C 530) when applying audit sampling (improper sampling techniques, inadequate documentation, etc.).
  - Failure to follow the provisions of the HUD audit guide (for-profit project owners).
  - Failure to use the OMB Compliance Supplement (nonprofit project owners).
  - Inadequate documentation of work performed.
  - Failure to obtain a management representation letter.

- Supervision:
  - Inadequate documentation of supervision of audit work.
- Reporting:
  - Deficiencies in the Schedule of Findings and Questioned Costs.
  - The auditor's opinion on the financial statements did not address the supplementary information in the FASSUB templates.
  - Material GAAP departures and internal control-related matters identified but not reported.
  - Attestation reporting not in accordance with professional standards.
  - Inadequate reporting of fraud and violations of laws and regulations. (HUD requires that those matters be reported to the HUD OIG single audit coordinator.)

The AICPA Peer Review Board periodically makes available some of the data collected during peer reviews. The AICPA has been studying the data with the goal of assisting firms in addressing challenges and providing tools aimed at increasing the quality of work done by accounting firms.

In addition, a Note at Paragraph 10.76 of the GAS/SA Audit Guide points out that some quality control reviews performed by federal agencies had findings in which audit documentation did not provide sufficient evidence that work was performed to support the auditor's opinion(s) on compliance. In certain cases, the audit documentation did not (a) contain evidence that the auditor tested certain compliance requirements applicable to a major program or (b) explain why certain compliance requirements that generally would be applicable were not considered by the auditor as applicable to a major program. Among other things, the auditor should document the individual tests performed and the results of those tests.

While auditors can create their own forms and style, the authors encourage auditors to use appropriate practice aids to ensure that required workpaper documentation is complete and clear for any peer reviewer or REAC auditor.

Other Audit Documentation Considerations

Retention. Auditors should establish policies and procedures regarding the retention of workpapers. These policies should be for a time frame that meets the needs of the auditor's practice and considers any regulatory or legal requirements regarding document retention. SQCS No. 8 (QM 10A.51) and AU-C 230.17 specifically indicates that this period should not be shorter than five years from the report release date. However, Paragraph 1-5(E) of the HUD audit guide requires auditors of for-profit HUD entities to keep the audit documentation and reports relating to HUD audits for a period of at least six years following submission of the report to HUD. For audits of nonprofit HUD entities, the Uniform Guidance requires the auditor to retain workpapers for at least three years after issuance of the reports. However, that period is extended to at least five years by AU-C 230. The minimum period may be extended upon written request by either HUD or the GAO. If the auditor is aware that HUD or the client is contesting an audit finding, the auditor may contact the HUD OIG single audit coordinator for further guidance regarding the length of time the related audit documentation should be held before destroying the workpapers and reports.

Ensuring the Integrity of Workpapers. According to SQCS No. 8 (QM 10A.50), firms should apply appropriate, reasonable controls to protect the integrity, retrievability, and accessibility of workpapers. Controls are necessary to prevent workpapers from unauthorized use or alteration or from becoming lost or damaged. According to QM 10A.A56, such controls may:

- Enable clear identification of when and by whom documentation was created, changed, or reviewed.
- Protect the integrity of the information at all stages of the audit. This is critical when the information is shared among the audit team or electronically transmitted to other parties.
- Permit necessary access to the documentation by the audit team or other authorized parties.
- Prevent unauthorized changes to documentation.

The Yellow Book, at paragraph 5.46, states that auditors should establish policies and procedures for the retention of engagement documentation for a period of time that is sufficient to meet legal, regulatory, and administrative requirements. It further states that when audit documentation is stored electronically, the auditor should establish information systems controls related to accessing and updating the audit documentation.

The authors recommend that firms develop consistent policies and underlying controls for all audit engagements that address integrity, retrievability, and accessibility. However, such controls may vary based on the stage of the audit (e.g., fieldwork still in progress, after fieldwork but before the documentation completion date, and after the documentation completion date) and the nature of the workpaper media (e.g., paper or electronic).

Loss of Client Records or Audit Documentation

The AICPA has issued the following *Technical Questions and Answers* about what auditors might do if either the client's records or the auditor's audit documentation are lost or destroyed:

- *Audit Considerations When Client Evidence and Corroborating Evidence in Support of the Financial Statements Has Been Destroyed by Fire, Flood, or Natural Disaster* (Q&A 8345.01), addresses the impact on the auditor's report when some or all of an entity's accounting records have been destroyed. If engaged by the client, auditors would normally disclaim an opinion on the financial statements if substantially all of the supporting records have been destroyed. If appropriate, auditors may report on specific elements of the financial statements.

- *Considerations When Audit Documentation Has Been Destroyed by Fire, Flood, or Natural Disaster* (Q&A 8345.02), addresses the destruction of audit documentation by fire, flood, or natural disaster. The authors believe the guidance also would apply if workpapers are lost, deleted, or damaged due to other circumstances. The Q&A indicates that if audit documentation is destroyed prior to the issuance of the auditor's report, the auditor needs to either recreate the audit documentation for the procedures performed or reperform the audit procedures and create new documentation. The auditor cannot issue a report indicating that he or she has performed an audit under professional standards without the required documentation. Oral explanations cannot be used as the principal support for the work that was performed. When determining whether to recreate the documentation or reperform the procedures, the auditor needs to consider whether he or she will be able to demonstrate that sufficient audit evidence has been obtained to afford a reasonable basis for expressing an opinion on the financial statements. Except for very small engagements, the authors believe it is unlikely that the auditor will be able to recreate sufficient documentation without reperforming at least some of the procedures.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

26. Which of the following statements best describes the use of audit sampling in a HUD audit?
    a. Statistical sampling is appropriate for a HUD audit, but nonstatistical sampling is not.
    b. Three distinct types of audit procedures may use audit sampling in HUD audit engagements.
    c. Auditors cannot perform dual-purpose testing to the same audit sample during a HUD audit.
    d. HUD audits are exempt from AU-C 530 when designing tests of transactions using audit sampling.
27. Management's representations in the financial statements are called what?
    a. Assertions.
    b. Key audit matters.
    c. Audit objectives.
    d. Audit procedures.
28. According to SQCS No. 8 (QM 10A.50), a firm's controls over its workpapers should do which of the following?
    a. Protect the integrity of the engagement in the final stage of the audit.
    b. Provide access to the documentation to members of the public.
    c. Establish information system controls for audit documentation stored electronically.
    d. Enable clear identification of when and by whom the documentation was created, changed, and reviewed.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

26. Which of the following statements best describes the use of audit sampling in a HUD audit? **(Page 403)**

    a. Statistical sampling is appropriate for a HUD audit, but nonstatistical sampling is not. [This answer is incorrect. Audit sampling does not equate to statistical sampling. Audit sampling can be either statistical sampling or nonstatistical sampling, and that does not change when the auditee is a HUD-assisted entity. In fact, the PPC approach to audit sampling, which can be used for HUD audits, is nonstatistical.]

    b. **Three distinct types of audit procedures may use audit sampling in HUD audit engagements. [This answer is correct. In a HUD engagement, three distinct types of audit procedures may involve the use of audit sampling: (1) substantive tests of details of account balances, (2) substantive tests of details of transactions, and (3) tests of controls directed toward operating effectiveness.]**

    c. Auditors cannot perform dual-purpose testing to the same audit sample during a HUD audit. [This answer is incorrect. When performing a HUD engagement, auditors may perform dual-purpose tests that apply both tests of details and tests of controls to the same sample of items.]

    d. HUD audits are exempt from AU-C 530 when designing tests of transactions using audit sampling. [This answer is incorrect. AU-C 530 establishes requirements for the planning, selection, performance, and evaluation of sampling in tests of transactions. That guidance applies to HUD audits the same way it applies to other audit engagements.]

27. Management's representations in the financial statements are called what? **(Page 405)**

    a. **Assertions. [This answer is correct. In forming an opinion on the financial statements and performing procedures related to HUD program compliance, the auditor obtains and evaluates evidence about the assertions made by management. AU-C 315A.04 explains that *assertions* are management's representations in the financial statements, whether or not explicit, that the auditor uses to consider the types of potential misstatements that might occur.]**

    b. Key audit matters. [This answer is incorrect. Communication of key audit matters (KAMs) is not required in audits of nonissuers, unless the auditor is engaged to report KAMs. However, this is a different consideration than the term used for management's representations.]

    c. Audit objectives. [This answer is incorrect. An audit objective is, in effect, an assertion translated into terms relevant to a specific account or HUD program. When the assertions are restated in specific terms for an account or program, they become audit objectives for an auditor to achieve in designing an audit program.]

    d. Audit procedures. [This answer is incorrect. Auditors perform these to (1) obtain an understanding of the entity and its environment, including its internal control, to assess the risks of material misstatement at the financial statement and relevant assertion levels; (2) when applicable, test the operating effectiveness of controls in preventing or detecting material misstatements at the relevant assertions level; and (3) detect material misstatements at the relevant assertion level.]

28. According to SQCS No. 8 (QM 10A.50), a firm's controls over its workpapers should do which of the following? **(Page 414)**

    a. Protect the integrity of the engagement in the final stage of the audit. [This answer is incorrect. Per SQCS No. 8, the controls should protect the integrity of the information at *all stages* of the audit (not just in the final stage). This is critical when the information is shared among the audit team or electronically transmitted to other parties.]

b. Provide access to the documentation to members of the public. [This answer is incorrect. As indicated by SQCS No. 8, the controls should permit necessary access to documentation by the audit team or other authorized parties, not the public at large.]

c. Establish information system controls for audit documentation stored electronically. [This answer is incorrect. The Yellow Book (not SQCS No. 8) states that when audit documentation is stored electronically, the auditor should establish information systems controls related to accessing and updating the audit documentation.]

d. **Enable clear identification of when and by whom the documentation was created, changed, and reviewed. [This answer is correct. Controls are necessary to prevent workpapers from unauthorized use or alteration or from becoming lost or damaged. According to QM 10A.A56, such controls may, among other things, enable clear identification of when and by whom documentation was created, changed, or reviewed, and prevent unauthorized changes to documentation.]**

SPECIAL PLANNING CONSIDERATIONS THAT MAY APPLY TO INITIAL ENGAGEMENTS

AU-C 300.13 provides guidance on considerations for planning an initial audit engagement. Because the auditor may lack experience with the client, additional planning procedures are generally necessary in order to develop the audit strategy and audit plan. Applicable regulatory requirements should also be considered.

Audit of a Previously Audited HUD-assisted Entity

When an entity has been audited previously, communicating with the predecessor auditor is a necessary procedure because the predecessor auditor may be able to provide information that will assist the successor auditor in determining whether to accept the engagement.

The precise form of the communication with a predecessor is not specified by professional standards. For example, a written communication is not required—simply talking with the predecessor is enough. The essential aspects of the communication are as follows:

- *Client Permission.* An auditor should ask the prospective client to authorize the predecessor to respond fully. (This is necessary because of the ethical requirement for confidentiality.)
- *Specific Questions.* An auditor may ask specifically about certain matters such as:
  - Information that might bear on management's integrity.
  - Disagreements with management on accounting principles, auditing procedures, or similar matters.
  - The predecessor's understanding of reasons for the change of auditors.
  - Communications with those charged with governance regarding fraud and noncompliance with laws and regulations by the entity.
  - Communications with management and those charged with governance regarding internal control matters.

AU-C 510.05 defines the term *predecessor auditor* as an auditor from a different firm who reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements. That may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements (that is, a successor auditor) who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit. Communication about management integrity and other matters may be made of all predecessor auditors. However, when a predecessor did not complete the audit, it is less likely the auditor will consider it appropriate to review the predecessor's workpapers.

Communications after acceptance that may facilitate the successor's audit generally fall in the following categories:

- Inquiries of the predecessor regarding matters that the successor believes may affect the conduct of the audit, such as audit areas that have required an inordinate amount of time or audit problems that arose from the condition of the financial reporting system and records.
- Review of the predecessor auditor's workpapers.

The successor auditor has to request the client to authorize the predecessor auditor to allow a review of the predecessor's workpapers. Generally, it is more efficient to make this request at the same time permission is requested concerning the inquiries to be made before acceptance.

The successor's review of the predecessor's workpapers has two aspects. The first is a general review to make a preliminary assessment of whether the predecessor's audit was made in accordance with GAAS and can be relied on. During this phase, the auditor would review the audit plan and audit programs (unless the predecessor considers the programs proprietary in nature), including particularly the analysis of the risk of material misstatements and the understanding of internal control. The auditor would consider the apparent understanding of the client, its systems, its operations, and its accounting policies obtained by the predecessor and the general quality of the documentation of these matters. If there is a summary memorandum of significant accounting and auditing issues, the successor would consider it carefully.

The second aspect of the successor's review is a detailed consideration of trial balances, account balance analyses, adjusting journal entries, and items from the permanent files such as contracts, carryforward schedules, and other workpapers in important audit areas. The successor should request copies of workpapers of continuing accounting significance.

HUD Audit Guide Requirements—For-profit Audits. Paragraph 1-5(A)(7) of the HUD audit guide indicates that, before issuing the engagement letter, the auditor normally contacts the predecessor auditor to review the audit documentation supporting the prior financial statement audit and any findings included in the predecessor auditor's compliance report. The auditor may also need to discuss with the predecessor auditor matters that are not adequately explained or documented in the audit documentation or a preexisting condition the auditor notes in the review that was not in the prior audit report. If the predecessor auditor refuses to allow the successor auditor access to that information or to discuss such matters, the successor auditor should include in the engagement letter statements that (a) the auditee grants permission for the successor auditor to discuss and review the prior audit documentation and (b) the auditee is to make the appropriate arrangements.

Audits of Financial Statements Previously Audited (Reaudits)

An auditor may be asked to audit and report on an entity's financial statements for a period that was previously audited and reported on by a predecessor auditor (a reaudit). This differs from the situation discussed at the beginning of this section in which the auditor is reporting on the financial statements for a period subsequent to the period audited and reported on by the predecessor auditor. The following paragraphs discuss issues when an auditor is performing a reaudit.

The following questions have arisen in practice about the responsibilities of the successor and predecessor auditor in a reaudit:

- What communications are required between the successor and predecessor auditors, and when?
- How much audit evidence can be obtained from the work of the predecessor auditor?
- What is the impact on the successor auditor's report?

Those matters are discussed in the following paragraphs.

Communications with the Predecessor Auditor. As discussed earlier, the successor auditor is required to ask management to authorize the predecessor to allow a review of the predecessor's workpapers and to respond fully to the successor's inquiries regarding matters that will assist in the engagement acceptance decision. If management refuses, or limits the predecessor's response, the auditor should inquire about the reasons and consider their implications when deciding whether to accept the engagement. These communications should also be made when engaged to audit and report on financial statements previously audited and reported on by a predecessor auditor. When making the inquiries, the successor auditor needs to clearly communicate that the purpose of his or her communications is to obtain information about whether to accept an engagement to report on financial statements previously audited and reported on by the predecessor auditor.

When the auditor has been engaged to audit and report on financial statements for a period previously audited by a predecessor auditor, the successor would normally request access to and review the predecessor's workpapers for the period under audit (the reaudit period) and the period prior to the reaudit period. As discussed in this section, after accepting a new engagement, the successor auditor usually requests access to the predecessor's workpapers for the prior period to plan the audit, obtain evidence about beginning balances, and evaluate the consistency in application of accounting principles. In a reaudit situation, the auditor reviews the workpapers for the period to be reaudited for purposes of obtaining information to be used in planning his or her reaudit.

Using the Work of the Predecessor. When performing a reaudit, the successor auditor reviews the predecessor's workpapers for the reaudit period and the period prior to the reaudit period. However, the purpose of the successor's review of the predecessor's workpapers for the reaudit period cannot be to use the predecessor's workpapers as evidence. Instead, the purpose for reviewing the workpapers for the reaudit period is to obtain information that might be useful in planning the reaudit.

In other words, the successor auditor should perform the procedures considered necessary to report on the financial statements as if they had not been audited by the predecessor auditor. For example, the successor auditor cannot use the confirmation procedures documented in the predecessor's workpapers as evidence to support the existence of investments. Additional procedures, such as sending additional confirmations, need to be performed by the successor auditor. The successor accepts sole responsibility for the nature, timing, and extent of audit work performed and conclusions reached.

For purposes of substantiating the beginning balances of the reaudit period and evaluating the consistency in application of accounting principles, the successor auditor may use information from the predecessor's workpapers for the period prior to the reaudit period. The guidance in the "Audit of a Previously Audited HUD-assisted Entity" discussion at the beginning of this section would apply to the review of the workpapers for the period prior to the reaudit period.

Providing Access to Workpapers in a Reaudit Situation. When the predecessor auditor is requested to provide access to workpapers in a reaudit situation, it is generally considered a professional courtesy to provide that access. However, there may be circumstances in which the request should not be accommodated. One solution is for the predecessor to provide access only to workpapers for the period *prior* to the reaudit period. Another is for the predecessor to obtain written confirmation from the successor that the successor accepts sole responsibility for the nature, timing, and extent of audit work performed and conclusions reached as a basis for the successor's report on the reaudited periods.

PERFORMING AUDITS OF GROUP FINANCIAL STATEMENTS

Authoritative Literature

This section explains the special considerations that apply to the audit of group financial statements, particularly the effect of the work of component auditors. The authoritative literature that applies to group audits is AU-C 600, *Special Considerations—Audits of Group Financial Statements (Including the Work of Component Auditors)*. The objectives of AU-C 600 are summarized later in this section.

Approach to Presentation of Group Audit Requirements. Planning and performing an audit of group financial statements (group audit) involves all of the same steps in the audit process as in a GAAS audit. In a group audit, however, each of those steps has special considerations that apply particularly to a group audit. The approach in this section is to focus on those special considerations and aspects of group audits that are incremental to the normal audit steps. However, the procedures performed, information obtained, and decisions reached are generally done as an integral part of performing and documenting the usual steps in an audit. A discussion addressing documentation requirements and practical guidance when aggregated audit procedures may be performed is provided later in this section.

Definitions Relevant to Group Audits. Three important terms to understand in determining whether AU-C 600 applies are defined in AU-C 600.11 as follows:

- *Group financial statements*—financial statements that include the financial information of more than one component.
- *Component*—an entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the group financial statements.
- *Component auditor*—an auditor who performs work on the financial information of a component that will be used as audit evidence for the group audit.

As explained in more detail in the following paragraphs, certain requirements of AU-C 600 apply any time the auditor is auditing group financial statements, that is, when there is more than one component included in the financial statements. Additional requirements apply when there are one or more component auditors.

Consolidated financial statements are obviously group financial statements, but also included are combined financial statements that aggregate the financial information of components under common control as well as financial statements that aggregate other organizational structures, such as branches, divisions, or geographical locations, for which group management prepares financial information.

A component auditor may be part of the group engagement partner's own firm, a network firm of the group auditor, or another auditing firm. Auditors who are not members of the group engagement team are considered to be component auditors. Even when firm offices other than the lead partner's office are involved in the audit, the requirements of AU-C 600 apply. The AICPA Question and Answer at Q&A 8800.24, *Applicability of AU-C Section 600 When Only One Engagement Team is Involved*, explains that while certain considerations related to component auditors are not relevant, other considerations, such as understanding components, identifying significant components, and identifying component materiality are relevant to all group audits. As a practical matter, these requirements would not normally be difficult to meet, but may require additional documentation.

In other words, AU-C 600 applies to all audits of group financial statements whether or not there are auditors involved who are not members of the group engagement team. An auditor who performs work on a component when the group engagement team will not use that work to provide audit evidence, however, is not considered a component auditor.

Considerations for Audits of HUD-assisted Entities

The authors believe that few HUD audit engagements will be group audits as defined in GAAS because most HUD-assisted projects are owned by single-asset entities and are not included in consolidated (group) financial statements. However, an auditor of a HUD-assisted entity may need to consider the requirements of AU-C 600 both in the context of the entity that is being audited and his or her role in the audit engagement. The following paragraphs describe situations in which the requirements could apply in a HUD audit engagement.

It was not uncommon in the past for multiple HUD-assisted projects to share a single federal tax identification number (TIN). When multiple projects have the same TIN, HUD provides project owners with the option of submitting either a single audited financial statement, or a consolidated audited financial statement that covers all projects and the overall ownership entity. Another situation that involves consolidated entities could occur when a nonprofit or governmental entity (for example, a local public housing authority) has created a single-asset entity to own a HUD-assisted project.

Both situations described in the previous paragraph involve group financial statements at the level of the parent reporting entity; for example, the nonprofit or governmental entity may present consolidated financial statements at the organization-wide level. The auditor that is engaged to perform the HUD audit of the single asset HUD-assisted entity may be different than the auditor that performs the group audit. In this case, the auditor of the single-asset entity may be a component auditor, and the auditor of the parent entity may be part of the group engagement team.

The guidance in AU-C 600 may also be relevant in other situations. AU-C 600.02 states that the guidance on group audits may be useful when other auditors are involved in an audit of financial statements that are not group financial statements. Nonauthoritative guidance from the AICPA in Q&A 8800.43, *Using Another Accounting Firm to Perform Inventory Observations*, provides an example of an accounting firm that outsources year-end inventory observation to another accounting firm due to location of the inventory. In this situation, the other auditor performing inventory observation is not a component auditor. However, in the audit of a HUD-assisted entity, a situation analogous to an inventory count is when the auditor contracts with another auditor to perform audit procedures on-site at an apartment complex that is far away. AU-C 600.02 states an auditor may find that AU-C 600, adapted as necessary in the circumstances, is useful when other auditors are involved in the audit of financial statements that are not group financial statements. The authors recommend that auditors review and adapt the guidance from AU-C 600 that is discussed in the remainder of this section when other audit organizations are used in their HUD audit engagement.

Q&A 8800.43 further explains that AU-C 220A, *Quality Control for an Engagement Conducted in Accordance With Generally Accepted Auditing Standards*, requires the engagement partner to be satisfied that those performing the audit possess the appropriate competence and capabilities. In accordance with AU-C 220A.17, the engagement partner is responsible for the direction, supervision, and performance of the audit engagement. The requirements and application material in AU-C 600 relating to understanding a component auditor, setting materiality, determining the type of work to be performed, and involvement in the work performed by component auditors provide relevant guidance for meeting the requirements in AU-C 220A with regard to the other auditor.

Applicability to an Audit of Compliance. Paragraph 6.57–.58 of the GAS/SA Audit Guide indicate that AU-C 600 is not directly applicable to a compliance audit. They explain that AU-C 600, in part, addresses the audit risk that results from the aggregation of component financial information (which it refers to as *aggregation risk*). The GAS/SA Audit Guide further explains that, because each major program is opined on separately in a compliance audit, the concept of aggregation risk is not directly applicable. Furthermore, because the focus of the compliance audit is attribute based (i.e., there is either compliance or noncompliance), the concept would not be relevant even if a major program is administered by multiple locations. Thus, the consideration of a component would generally only be applicable if other auditors have been separately engaged to perform part of the compliance audit.

Determining Whether to Act as the Auditor of Group Financial Statements

AU-C 600.14 indicates that the group engagement partner should determine whether sufficient appropriate audit evidence can reasonably be expected to be obtained regarding the consolidation process and the financial information of the components on which to base the group audit opinion. To make this determination, the group engagement team should obtain an understanding of the group, its components, and their environments sufficient to identify components that are likely to be significant components.

A *significant component*, according to AU-C 600.11, is one that—

a. is of individual financial significance to the group, or

b. due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

The identification of components that are likely to be significant components is preliminary based on the initial understanding and is either confirmed or revised when the auditor later enhances this understanding by performing additional risk assessment procedures.

In making the determination to act as group auditor, the group engagement partner evaluates whether sufficient appropriate evidence can be obtained through the engagement team's own work or using the work of component auditors—either by assuming responsibility for their work or through making reference to them. In deciding whether to act as group auditor, relevant factors include the materiality of the portion of the financial statements to be audited in comparison with the portion to be audited by component auditors, the extent of knowledge of the overall financial statements, and the extent to which significant risks of material misstatement of the group financial statements are included in components audited by component auditors.

Identifying Components and Significant Components

Identifying Components. The group engagement team identifies the components that are included in the group financial statements when they obtain an understanding of the group. This ordinarily involves considering the structure of the group and the nature of the financial information, and the manner in which it is accumulated and reported by the group financial reporting system, including the consolidation process. AU-C 600 allows significant judgment in determining components. Thus, the authors recommend keeping this process as straight forward and high level as possible in order to increase audit efficiency. In many HUD audits identification of components may be relatively straight-forward.

When obtaining an understanding of the entity, the auditor may consider the type, quantity, and quality of information available at the components identified by management because that may indicate whether it would be appropriate to identify them as components for purposes of the audit.

Significant Components. A *significant component* is one that either is of individual financial significance to the group or, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements. The determination of whether a component is significant is important because greater audit effort needs to be directed to significant components. For example, AU-C 600.53 requires all financially significant components to be audited.

Determining Whether to Make Reference to the Audit of a Component Auditor

AU-C 600.22 indicates that regardless of the decision concerning reference, the auditor should obtain an understanding of a component auditor. The understanding may affect the group auditor's risk assessment process, the nature and extent of further audit procedures, and audit conclusions. However, it is not necessary to obtain an understanding of the auditors of components when the group auditor will not use their work to provide audit evidence for the group audit, such as when the group auditor will perform only analytical procedures at the group level for those components. The understanding of a component auditor should include the following:

- The component auditor's understanding of and willingness to comply with relevant ethical requirements, including independence requirements.
- The component auditor's professional competence.
- The extent of involvement the group engagement team will be able to have in the work of the component auditor.
- The ability of the group engagement team to obtain information affecting the consolidation process from a component auditor.
- The extent to which the component auditor operates in a regulatory environment that actively oversees auditors.

In the initial year of a group audit, information about the component auditor may be obtained by communicating with the component auditor, visiting the component auditor, reviewing peer review or inspection reports, or inquiring of other auditors, bankers, or creditors about the component auditor's professional reputation and standing. Information about competence may also be obtained from the AICPA, state licensing boards, state societies of CPAs, or other professional organizations. In addition, the group auditor may become aware of competency issues by simply reading the financial statements audited by the component auditor. After the initial year, this understanding may be based on previous experience with the component auditor, and the component auditor may be requested to confirm whether anything has changed. Naturally, when a component auditor is another domestic office of the same firm, this information will generally be known, and obtaining the understanding about independence and competence may be limited to reviewing the results of quality control monitoring (for example, monitoring of independence and continuing professional education).

AU-C 600.23 and AU-C 600.25 indicate that reference to the audit of a component auditor should not be made unless all of the following conditions are met:

- The component auditor understands and will comply with independence and other ethical requirements.
- The component auditor is competent.
- The component auditor performed its audit in accordance with GAAS.
- The component auditor's report is unrestricted as to use.

If the component auditor does not meet independence requirements or there are serious concerns about competence, the auditor should not make reference to the component auditor or otherwise make use of the work of that component auditor. A component auditor's lack of industry-specific knowledge or other less serious concerns about competence do not preclude making reference to the component auditor if the concerns can be overcome by the group auditor being more involved in the component auditor's work or performing additional procedures on the component's financial information.

The condition requiring the component auditor's report to be unrestricted would not be applicable to the type of restriction used in the auditor's report on internal control or compliance issued in an audit performed under Yellow Book requirements. AU-C 905.A11 provides illustrative language that describes the purpose of the auditor's communication and states that it is not suitable for any other purpose. However, the illustrative language does not restrict use of the report. The decision about whether to make reference to the work of a component auditor should be documented.

Communications with Component Auditors

AU-C 600 emphasizes the importance of effective two-way communication between the group auditor and component auditors. It provides specific requirements about information that should be obtained from component auditors and information that should be provided to component auditors. When making reference to a component auditor, the communications generally are as follows:

- Communication about the matters in AU-C 600.23 and AU-C 600.25 listed above.
- Communication of requirements to the component auditor, including—
  - a request for cooperation that specifies the context in which their work will be used,
  - a list of known related parties (including the nature of the related-party relationships and transactions) and a request for notification about other unidentified related parties,
  - identified significant risks of material misstatement of the group financial statements that are relevant to their work, and
  - a request for notification of subsequent events that may require adjustment to, or disclosure in, the group financial statements.
- Communication of findings from the component auditor, including the financial statements and their auditor's report.

The group auditor should read the component's financial statements and auditor's report, if applicable; evaluate other communications received from component auditors; and discuss significant findings and issues with the component auditor, component management, or group management, as appropriate. If there are no findings (such as previously unidentified related parties or subsequent events) the communication from the component auditor to whom reference will be made may consist of a transmittal of the financial statements and their auditor's report.

When assuming responsibility for the work of a component auditor, the communications are more extensive and generally include the following:

- Communication about competence and compliance with independence and other ethical requirements.
- Communication of group audit requirements to the component auditor, including—
  - a request for cooperation that specifies the context in which their work will be used;
  - the work to be performed;
  - the form and content of their expected communication;
  - in the case of an audit or review, component materiality; materiality for particular account balances, transaction classes, or disclosures (if applicable); and the threshold for trivial misstatements;
  - a list of known related parties (including the nature of the related-party relationships and transactions) and a request for notification about other unidentified related parties;
  - identified significant risks of material misstatement of the group financial statements that are relevant to their work; and

- •• a request for notification of subsequent events that may require adjustment to, or disclosure in, the group financial statements.

- Communication of findings and conclusions from the component auditor that identifies the financial information about which they are communicating and indicates—
  - •• whether they complied with the group auditor's requirements;
  - •• material noncompliance with laws and regulations;
  - •• significant risks of material misstatement of the group financial statements identified by them and their responses;
  - •• corrected and uncorrected misstatements that exceed the threshold for trivial misstatements;
  - •• indicators of possible management bias in accounting estimates and the application of accounting principles;
  - •• material weaknesses and significant deficiencies in internal control at the component;
  - •• other significant findings or issues, such as fraud or suspected fraud, that will be communicated to those charged with governance of the component; and
  - •• any other matters relevant to the group audit, including exceptions to component management representations.

Communication about competence and compliance with independence and other ethical requirements to obtain an understanding of the component auditor often takes the form of a confirmation. The group engagement team's requirements are often communicated in a letter of instructions. A component auditor's communication often takes the form of a memo or report of work performed.

AU-C 600.50 indicates that the audit documentation should include written communications between the group engagement team and component auditors about the group engagement team's requirements. Any written communications should be included in the workpapers. The component's financial statements and auditor's report, if applicable, should also be included in the workpapers. In the absence of written communication, the requirement to document the nature, timing, and extent of involvement in the component auditor's work, including the review of their documentation and conclusions thereon, as well as general requirements for audit documentation apply.

The group engagement team normally communicates its instructions to the component auditor as soon as possible. Typically, this communication occurs at the earlier of (a) the component auditor's planning for the audit or review of the component or (b) the group engagement team's planning for the group audit. Also, the authors recommend that the group engagement team establish expectations regarding the timing of communications between the group and component auditors about important engagement matters, such as unidentified related parties, significant unusual transactions, or significant other issues that may affect the group audit. However, by their nature, certain matters might only be communicated when the component auditor issues his or her overall findings, conclusions, or opinion.

Communication with the group auditor about matters of significance to the component may be initiated by the component auditor. Matters of significance to the component may include (a) transactions, adjustments, or other matters that have come to the group engagement team's attention that may require adjustment to or disclosure in the component's financial statements or (b) limitations on the scope of the group audit that relate to the component's financial statements or that limit the group auditor's ability to respond to the component auditor's inquiries. If the group auditor reports any such scope limitations, or if the group audit has not progressed to a point sufficient for providing the requested information, the component auditor may need to determine acceptable alternative procedures, delay issuance of the report on the component financial information until the group auditor can respond, or modify the opinion on the component for a scope limitation.

Obtaining Sufficient Appropriate Evidence on Group Financial Statements

A group audit, as explained earlier, involves the same steps as other GAAS audits. In a group audit, however, there are several matters with respect to audit work performed that are in addition to or an expansion of audit work in a GAAS audit. These matters include the following:

- Obtaining an understanding of group-wide controls.
- Obtaining an understanding of the consolidation process.
- Determining component materiality.
- Other procedures when assuming responsibility for the work of component auditors.

Group-wide Controls. These are controls designed, implemented, and maintained by group management over group financial reporting. This understanding is obtained as part of understanding the group, its components, and their environment. According to AU-C 600.33, if the nature, timing, and extent of the work to be performed on the consolidation process are based on an expectation that group-wide controls are operating effectively, those controls should be tested. The tests can be performed by the group engagement team or by a component auditor on the team's behalf.

Consolidation Process. The group engagement team should obtain an understanding of the consolidation process for preparing the group financial statements, including the instructions issued by group management to components. As part of that understanding, the group auditor considers whether the reporting instructions issued to components are clear and whether they (a) adequately describe the accounting policies to be followed, (b) address disclosures needed to comply with GAAP, (c) provide a means of identifying intercompany balances and transactions, and (d) require approval of financial information by component management.

The group engagement team also should perform procedures to achieve the following audit objectives:

- Design and perform further audit procedures on the consolidation process to respond to assessed risks of material misstatement of the group financial statements arising from the consolidation process.
- Evaluate whether all components have been included in the group financial statements.
- Evaluate the appropriateness, completeness, and accuracy of consolidation adjustments and reclassifications.
- Evaluate whether any fraud risk factors or indicators of possible management bias exist.
- Determine whether the financial information identified in the component auditor's communication is the information incorporated in the consolidation.
- Determine whether appropriate adjustments have been made when the financial information of a component is not prepared on the same accounting basis as the group financial statements or when the component has a year end that differs from the group's year end.

These audit objectives generally are achieved by performing the tests for investments accounted for by the equity or consolidation method.

Component Materiality. In accordance with AU-C 600.53–.54, the group auditor should determine component materiality for planning purposes for those components on which the group engagement team will perform (or assume responsibility for the work of a component auditor who performs) an audit or review of component financial information. When a separate auditor's report will be issued on the financial statements of a component (regardless of whether reference will be made), it can ordinarily be expected that the materiality amount determined by the component auditor for purposes of the separate report will be acceptable for purposes of the group audit. When reference is to be made to the component auditor, the group auditor is not required to establish materiality for the component auditor. The AICPA's nonauthoritative guidance in Q&A 8800.18, *Determining Component Materiality*, explains that reference in the group auditor's report to the fact that part of the audit was conducted by the component auditor is intended to communicate that the group auditor is not assuming responsibility for the work of the component auditor. In contrast, if the group auditor assumes responsibility for the work of the component auditor, the group auditor is required to determine, and communicate to the component auditor, the component materiality to use.

AU-C 600.32 explains that component materiality should be determined taking into account all components, regardless of whether reference is made to a component auditor. AU-C 600 also specifies that:

- Component materiality should be lower than the materiality for the group financial statements as a whole.
- Component performance materiality should be lower than performance materiality for the group financial statements as a whole.
- Different component materiality amounts may be established for different components.
- The aggregate of component materiality may exceed group materiality.

In other words, component materiality need not be determined based on the ratio of each component's benchmark (such as total assets or total revenue) to the group benchmark. A straight allocation of group materiality is not required, but AU-C 600 does not provide specific guidance about how to determine component materiality.

Component materiality is used for audit planning purposes and not for evaluation of misstatements detected. The sum of uncorrected misstatements, and any allowance made for undetected misstatements at components has to be compared to group materiality in evaluating whether the group financial statements are materially misstated. In other words, even though the total of component materiality amounts may exceed group materiality, the sum of audit differences for all components cannot exceed group materiality when evaluating audit results.

Additional Procedures When Assuming Responsibility for the Work of Component Auditors. If the group engagement partner has decided to assume responsibility for the work of a component auditor, then the additional requirements in Exhibit 3-1 apply.

Exhibit 3-1

Additional Requirements of AU-C 600
When Assuming Responsibility for Work of a Component Auditor (based on AU-C 600.51–.65)

1. Evaluate the appropriateness of performance materiality at the component level, that is, evaluate how the component auditor applied component materiality to determine the scope of substantive procedures.
2. Determine the type of work to be performed (either by the group engagement team or by component auditors on their behalf) on the financial information of components for which reference will not be made.
   a. For components that are significant due to their financial significance to the group, the type of work should be an audit of the financial information using component materiality (adapted as necessary).
   b. For components that are significant because they are likely to include significant risks of material misstatement of the group financial statements due to their specific nature or circumstances (rather than because of financial significance), perform one or more of the following:
      (1) An audit of the component financial information using component materiality (adapted as necessary).
      (2) An audit of one or more account balances, classes of transactions, or disclosures relating to the likely significant risks of material misstatement of the group financial statements (adapted as necessary).
      (3) Specified audit procedures relating to the likely significant risks of material misstatement of the group financial statements.
   c. For components that are not significant, perform analytical procedures at the group level. These procedures might include scanning the account balances of the component to identify significant fluctuations and other analytical procedures tailored to the nature and circumstances of the component. Any questions

that arise from these analytical procedures that cannot be resolved satisfactorily may require additional detailed audit procedures.

d. If sufficient appropriate evidence is not obtained from the work performed on significant components, analytical procedures at the group level, and the work performed on group-wide controls and the consolidation process, select additional components that are not significant and perform one or more of the following:

   (1) An audit of the component financial information using component materiality (adapted as necessary).

   (2) A review of the component financial information using component materiality (adapted as necessary).

   (3) An audit of one or more account balances, classes of transactions, or disclosures (adapted as necessary).

   (4) Specified audit procedures.

This may occur, for example, when several components are not individually significant to the group financial statements but are material in the aggregate. The auditor should vary the selection of individual non-significant components over time.

Adapted as necessary means the work may be modified to exclude some procedures that are performed at the group level such as work on litigation, claims, and assessments.

3. When a component auditor performs work on the financial information of a significant component, involve the group engagement team in the identification and assessment of significant risks of material misstatement of the group financial statements. This involvement, at a minimum, should include the following:

   a. Discussing the component's business activities of significance to the group with the component auditor or component management.

   b. Discussing with the component auditor the susceptibility of the component's financial information to material misstatement resulting from error or fraud.

   c. Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements.

4. Evaluate the appropriateness of the component auditor's planned audit procedures to respond to identified significant risks of material misstatement of the group financial statements and determine whether it is necessary to be involved in their performance.

5. Determine based on communications from the component auditor whether it is necessary to review other parts of the component auditor's audit documentation.

6. If the component auditor's work is insufficient, perform additional procedures or request that the component auditor perform them.

7. Determine which material weaknesses and significant deficiencies communicated by the component auditor should be communicated to group management and those charged with governance.

8. Include the following in the group audit documentation:

   a. The nature, timing, and extent of the group auditor's involvement in the work performed by component auditors on significant components.

   b. If applicable, the review made of the component auditor's audit documentation and conclusions thereon.

When assuming responsibility for the work of component auditors, the group auditor is responsible for determining the type of work that component auditors should perform. For components that are financially significant to the group, AU-C 600.53 indicates that the type of work should be an audit of component financial information (adapted as necessary) using component materiality. Such an audit may also be performed on components that are not financially significant, as necessary to obtain sufficient audit evidence for the group financial statements.

Other Group Audit Requirements

AU-C 600 also establishes requirements in the following areas related to group audits:

- How to make reference in the group auditor's report to a component auditor.
- What procedures should be performed to identify subsequent events.
- What communications should be made to group management and those charged with governance.
- What to document concerning the group audit.

Audit Reporting. If the group auditor decides to assume responsibility for the work of a component auditor, then no reference should be made to that auditor's work in the auditor's report on the group financial statements. If the group auditor decides to make reference, then according to AU-C 600.28, the report should clearly indicate that the component was not audited by the group auditor, and should include the magnitude of the portion of the financial statements audited by the component auditor.

PPC's Guide to Auditor's Reports provides additional guidance and report examples for group audits, including how to make reference to a component auditor in the auditor's report on group financial statements, how to report when the component auditor's opinion is modified or their report includes an emphasis-of-matter or other-matter paragraph that affects the auditor's report on the group financial statements, and how to report when a component auditor is named in the auditor's report on the group financial statements.

Identification of Subsequent Events. When the group engagement team or component auditors perform audits of component financial information, procedures should be performed to identify events at the components that occur between the date of the component financial information and the date of the auditor's report on the group financial statements that may require adjustment to or disclosure in the group financial statements. Those procedures can be performed by either the group engagement team or a component auditor. When component auditors perform work other than an audit of component financial information and responsibility for that work is being assumed, the group engagement team should request that the component auditors notify the team if they become aware of events occurring between the date of the component financial information and the date of the auditor's report on the group financial statements that may require adjustment to or disclosure in the group financial statements.

Communications with Management and Those Charged with Governance. The group auditor should communicate the following matters to group management:

- Material weaknesses and significant deficiencies in internal control relevant to the group, whether identified by the group engagement team or by component auditors.
- Any fraud or indications of fraud identified by the group engagement team or brought to its attention by a component auditor. (Communication should be made on a timely basis to an appropriate level of group management.)

In addition, if information comes to the group engagement team's attention during the audit that may be significant to the financial statements of a component being audited by a component auditor, but of which component management may not be aware, the group auditor should ask group management to provide that information to component management. If management refuses, the group auditor should discuss the matter with those charged with governance. If the matter remains unresolved, the group auditor should consider whether to advise the component auditor not to issue their report until the matter is resolved and whether to withdraw from the engagement.

The group auditor should communicate the following matters to those charged with governance, in addition to those matters required by AU-C 260:

- Material weaknesses and significant deficiencies in internal control that are relevant to the group.
- An overview of the type of work to be performed on the financial information of components, including the basis for a decision to make reference to a component auditor in the auditor's report.
- An overview of the engagement team's planned involvement in the work to be performed by component auditors on significant components.
- Any instances in which evaluation of the work of a component auditor raised concerns about the quality of that work.
- Any limitations on the group audit, such as restricted access to information of components.
- Actual or suspected fraud involving (a) group management, (b) component management, (c) employees who have significant roles in group-wide controls, or (d) others where the fraud involves a material misstatement of the group financial statements.
- Any refusal by group management to discuss with component management a matter significant to the financial statements of the component.

Group Audit Documentation. The group engagement team should include the following in its audit documentation:

a. An analysis of components indicating—
   (1) Significant components.
   (2) The type of work performed on the financial information of components.
   (3) The components for which reference is made in the group auditor's report.
b. Written communications between the group engagement team and component auditors.
c. For any components for which reference is made, the audited financial statements and component auditor's report and, when the component auditor's report does not indicate that the audit of the component's financial statements was performed in accordance with GAAS, the basis for determining that the audit performed by the component auditor met the relevant requirements of GAAS.
d. When assuming responsibility for the work of a component auditor—
   (1) The nature, timing, and extent of the group auditor's involvement in the work performed by component auditors on significant components.
   (2) If applicable, the review made of the component auditor's audit documentation and conclusions thereon.

Using Other Auditors in Situations Other Than Group Audits

An auditor may involve other auditors in an audit of financial statements that are not group financial statements. Similarly, the group auditor (or a component auditor) may use other auditors in its audit of the parent entity (or a component). For example, the auditor may request other auditors to observe inventory or inspect physical assets in a remote location. If the remote location has not been identified as a component, the other auditor would not be considered a component auditor and AU-C 600 would not specifically apply to the use of such other auditor.

When an auditor involves other auditors in an audit of financial statements that are not group financial statements, it would not be appropriate to make reference to the work performed by the other auditors. That is, the auditor needs to assume full responsibility for the other auditors' work. The nonauthoritative guidance at Q&A 8800.43 explains that while the other auditor performing an inventory observation is not considered a component auditor if the financial statements are not group financial statements, the requirements of AU-C 220A apply and AU-C 600 provides useful guidance in meeting those requirements. AU-C 220A.16 requires the engagement partner to be satisfied that those performing the audit possess the appropriate competence and capabilities, and AU-C 220A.17 indicates the engagement partner is responsible for the direction, supervision, and performance of the engagement.

AU-C 600.02 notes that the standard may be adapted as necessary for those instances in which the other auditor is not a component auditor. For example, the auditor might consider the discussion earlier in this section regarding communications with component auditors. However, the auditor would only communicate (and request communications from the other auditor) on matters that are relevant to the procedures to be performed by the other auditor.

Similarly, entities that receive federal awards may engage accounting firms on a joint venture or subcontract basis due to requirements to make positive efforts to use small businesses, minority-owned firms, or women-owned business enterprises. The GAS/SA Audit Guide, Paragraph 6.59, indicates that in these circumstances, it usually is not appropriate to make reference to the other auditors. In the case of a joint audit, each of the auditors participating in the audit will sign the audit reports. The guidance in AU-C 600 is appropriate only when each auditor or firm has complied with GAAS and *Government Auditing Standards* and is in a position that would justify being the only signer of the report. In the case of a subcontract relationship, the subcontracting auditor often does not issue a separate report. Therefore, it would also not be appropriate to make reference to the subcontracting auditor in this situation.

SELF-STUDY QUIZ

Determine the best answer for each question below. Then check your answers against the correct answers in the following section.

29. Which of the following is true when performing an initial audit of a HUD-assisted entity that has previously been audited?

    a. Written communication with the predecessor auditor is required.

    b. Client permission is needed before contacting the predecessor.

    c. Another auditor at the same firm is considered a predecessor auditor.

    d. The auditor must rely on whatever information the predecessor chooses to offer.

30. What guidance applies to the determination of component materiality in an audit of group financial statements?

    a. Component materiality should be higher than materiality for the group financial statements as a whole.

    b. Component materiality should be the same for each component in the group financial statements.

    c. Component materiality must be determined based on the ratio of each component's benchmark to the group benchmark.

    d. Component materiality is used for audit planning purposes, not the evaluation of misstatements.

SELF-STUDY ANSWERS

This section provides the correct answers to the self-study quiz. If you answered a question incorrectly, reread the appropriate material in this lesson. **(References are in parentheses.)**

29. Which of the following is true when performing an initial audit of a HUD-assisted entity that has previously been audited? **(Page 420)**

    a. Written communication with the predecessor auditor is required. [This answer is incorrect. The precise form of the communication with a predecessor is not specified by professional standards. A written communication is not required—simply talking with the predecessor is enough.]

    b. **Client permission is needed before contacting the predecessor. [This answer is correct. An auditor should ask the prospective client to authorize the predecessor to respond fully. This is necessary because of the ethical requirement for confidentiality.]**

    c. Another auditor at the same firm is considered a predecessor auditor. [This answer is incorrect. AU-C 510.05 defines the term predecessor auditor as an auditor from a *different* firm who reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements. It may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements who did not complete the audit. However, that definition does *not* include another auditor at the same firm.]

    d. The auditor must rely on whatever information the predecessor chooses to offer. [This answer is incorrect. An auditor may ask the predecessor specifically about certain matters. The essential aspects of the communication do not specify that the auditor *must* rely on offered information without the opportunity to ask specific questions about certain matters.]

30. What guidance applies to the determination of component materiality in an audit of group financial statements? **(Page 429)**

    a. Component materiality should be higher than materiality for the group financial statements as a whole. [This answer is incorrect. As specified in AU-C 600, component materiality should be *lower* than the materiality for the group financial statements as a whole.]

    b. Component materiality should be the same for each component in the group financial statements. [This answer is incorrect. Per AU-C 600, different component materiality amounts may be established for different components. They do not all have to have the same materiality amount.]

    c. Component materiality must be determined based on the ratio of each component's benchmark to the group benchmark. [This answer is incorrect. Component materiality need *not* be determined based on the ratio of each component's benchmark (such as total assets or total revenue) to the group benchmark. A straight allocation of group materiality is not required, but AU-C 600 does not provide specific guidance about how to determine component materiality.]

    d. **Component materiality is used for audit planning purposes, not the evaluation of misstatements. [This answer is correct. Component materiality is used for audit planning purposes and not for the evaluation of misstatements detected. The sum of uncorrected misstatements and any allowance made for undetected misstatements at components has to be compared to group materiality in evaluating whether the group financial statements are materially misstated.]**

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to HUD Audits—Course 3—Pre-engagement Activities and Audit Planning (HUDTG223)

Testing Instructions

1. Following these instructions is an **Examination for CPE Credit** consisting of multiple choice questions. This course is designed so the participant reads the course materials, answers a series of self-study questions, and evaluates progress by comparing answers to both the correct and incorrect answers and the reasons for each. At the end of the course, the participant then answers the examination questions and records answers to those questions on either the printed **Examination for CPE Credit Answer Sheet** or by logging onto the Online Grading System. The **Examination for CPE Credit Answer Sheet** and **Self-study Course Evaluation Form** for each course are located at the end of the PDF and can be printed if needed.

2. **ONLINE GRADING.** Log onto our Online Grading Center at **cl.tr.com/ogs** to receive instant CPE credit. Click the purchase link and a list of exams will appear. Search for an exam using wildcards. Payment for the exam of $109 is accepted over a secure site using your credit card. Once you purchase an exam, you may take the exam three times. On the third unsuccessful attempt, the system will request another payment. Once you successfully score 70% on an exam, you may print your completion certificate from the site. The site will retain your exam completion history. If you lose your certificate, you may return to the site and reprint your certificate.

3. **PRINT GRADING.** If you prefer, you may email, fax, or mail your completed answer sheet, as described below ($109 for email or fax; $119 for regular mail). The answer sheet is found at the end of the **Examination for CPE Credit**. Answer sheets may be printed from the PDF; they can also be scanned to send via email, if desired. Each answer sheet is identified with the course acronym. Please ensure you use the correct answer sheet for the course. Indicate the best answer to the exam questions by completely filling in the circle for the correct answer. The bubbled answer should correspond with the correct answer letter at the top of the circle's column and with the question number. You may submit your answer sheet for grading three times. After the third unsuccessful attempt, another payment is required to continue.

   You may submit your completed **Examination for CPE Credit Answer Sheet**, **Self-study Course Evaluation**, and payment via one of the following methods:

   - Email to *CPLGrading@thomsonreuters.com*
   - Fax to **(888) 286-9070**
   - Mail to:

     Thomson Reuters
     Tax & Accounting—Checkpoint Learning
     HUDTG223 Self-study CPE
     36786 Treasury Center
     Chicago, IL 60694-6700

   Note: The answer sheet has four bubbles for each question. However, if there is an exam question with only two or three valid answer choices, "Do not select this answer choice" will appear next to the invalid answer choices on the examination.

   If you change your answer, remove your previous mark completely. Any stray marks on the answer sheet may be misinterpreted.

4. Each answer sheet sent for print grading must be accompanied by the appropriate payment ($109 for answer sheets sent by email or fax; $119 for answer sheets sent by regular mail). Discounts apply for three or more courses submitted for grading at the same time by a single participant. If you complete three

courses, the price for grading all three is $310 (a 5% discount on all three courses). If you complete four courses, the price for grading all four is $392 (a 10% discount on all four courses). Finally, if you complete five courses, the price for grading all five is $463 (a 15% discount on all five courses). The 15% discount also applies if more than five courses are submitted at the same time by the same participant. The $10 charge for sending answer sheets in the regular mail is waived when a discount for multiple courses applies.

5. To receive CPE credit, completed answer sheets must be postmarked or entered into the Online Grading Center by **November 30, 2023**. CPE credit will be given for examination scores of 70% or higher.

6. When using our print grading services, only the **Examination for CPE Credit Answer Sheet** and the **Self-study Course Evaluation** should be submitted. **DO NOT SEND YOUR SELF-STUDY COURSE MATERIALS.** Be sure to keep a completed copy of the answer sheet for your records.

7. Please direct any questions or comments to our Customer Service department at (800) 431-9025 (Option 2).

EXAMINATION FOR CPE CREDIT

Companion to PPC's Guide to HUD Audits—Course 3—Pre-engagement Activities and Audit Planning (HUDTG223)

Determine the best answer for each question below. Then mark your answer choice on the Examination for CPE Credit Answer Sheet. The answer sheet is located at the end of the exam and can be printed out, if desired. Alternatively, it can be accessed by logging onto the Online Grading System.

1. What type of requirements in generally accepted auditing standards (GAAS) and *Government Auditing Standards* (the Yellow Book) use the word *must*?

   a. Nonauthoritative.

   b. Optional.

   c. Presumptively mandatory.

   d. Unconditional.

2. The *Code of Professional Conduct* issued by the American Institute of Certified Public Accountants (AICPA) provides requirements related to which of the following?

   a. Ethical behavior.

   b. Quality management.

   c. Performing HUD audits.

   d. Peer reviews.

3. The auditors of HUD projects should comply with which independence regulations?

   a. All applicable regulations.

   b. Only the state board regulations of their licensing state.

   c. Only the AICPA and Securities and Exchange Commission (SEC) regulations.

   d. Only the Governmental Accountability Office (GAO) regulations.

4. If no circumstances exist that would cause a reasonably informed third party to conclude that an auditor's integrity, objectivity, or professional skepticism has been compromised, the auditor has what?

   a. Personal independence.

   b. Organizational independence.

   c. Independence of mind.

   d. Independence in appearance.

5. According to Paragraph 3.28 of the Yellow Book, how often should auditors reevaluate threats to independence and applied safeguards?

   a. Once every five years.

   b. Once each year.

   c. At the beginning and end of each audit.

   d. When new information or changes in facts and circumstances apply.

6. What might help if a threat to an auditor's independence is not at an acceptable level?
   a. Applying safeguards.
   b. Evaluating skill, knowledge, and experience (SKE).
   c. Performing nonaudit services.
   d. Using the Yellow Book's conceptual framework.
7. According to Paragraph 3.86 of the Yellow Book, which of the following is a condition that must be met for auditors to provide nonprohibited nonaudit services without impairing their independence?
   a. The nonaudit services must be expressly allowed and listed in the Yellow Book.
   b. The use of safeguards has been limited to the lowest amount possible.
   c. Yellow Book requirements for performing nonaudit services have been met.
   d. Documentation of the nonaudit services is sufficient.
8. The Yellow Book's requirement for using professional judgment when planning, performing, and reporting on audits is what type of requirement?
   a. Presumptively mandatory.
   b. Unconditional.
   c. Recommended.
   d. Optional.
9. What is the purpose of a verification review performed by the HUD's Real Estate Assessment Center (REAC)?
   a. Ensuring that an exit conference has been held with the appropriate HUD field office.
   b. Reviewing HUD engagements that are not required to obtain an audit.
   c. Enforcing the HUD's right to obtain access to required audit documentation.
   d. Confirming whether an auditor actually performed the documented audit steps and that they were performed based on the appropriate guidance.
10. Which of the following auditors correctly handled one of the preconditions for an audit?
    a. Patty considered the purpose and nature of the financial statements to determine if the financial reporting framework was acceptable.
    b. Kirk determined the financial reporting framework was acceptable after preparing the engagement letter.
    c. Taylor agreed to let client management pass all responsibilities to the audit firm.
    d. Mia accepted an engagement even though management imposed a scope limitation that would result in a disclaimer of opinion.

11. When should auditors make and document the decision of whether to continue an annual engagement?

    a. At the beginning of the engagement as part of engagement planning.

    b. After planning is complete but before fieldwork begins.

    c. Any time during the engagement as long as it is prior to the release of the report.

    d. At the conclusion of the engagement in advance of the next year's engagement.

12. Which of the following statements accurately describes how to establish the terms of an engagement?

    a. The HUD audit guide does not require a written understanding about the engagement.

    b. The Yellow Book requires a written engagement letter.

    c. Engagement letters should only be addressed to those charged with governance.

    d. Engagement letters should not contain information about the fee estimate.

13. According to *Consolidated Audit Guide for Audits of HUD Programs* (the HUD audit guide), what must an auditor include in an engagement letter?

    a. A list of the risk procedures that the auditor will perform.

    b. A list of adjustments needed to prepare GAAP-based financial statements.

    c. A list of information to provide for the audit and the date it is needed.

    d. A statement that the auditor plans to perform analytical procedures as part of risk assessment.

14. The HUD audit guide specifically requires auditors to do which of the following in relation to risk assessment during audit planning?

    a. Make inquiries of parties outside the entity to better understand the nature of operations.

    b. Limit the risk assessment procedures to only one type to avoid spending excess time in this area.

    c. Allow HUD to review and approve bids for audit fees submitted by the auditors.

    d. Opine on whether the audit client is in compliance with laws, regulations, and the provisions of contracts or grant agreements applicable to its major HUD programs.

15. How do the nature, timing, and extent of risk assessment procedures change across engagements?

    a. They should stay exactly the same from engagement to engagement.

    b. Some stay the same and others are tailored to each engagement.

    c. HUD provides a list specifically tailored to every entity's engagement.

    d. GAAP requires them to be unique for each engagement.

16. Can information gathered by performing risk assessment procedures in prior periods be used in a current-year HUD audit?

    a. No, all information is required to be gathered anew each year.

    b. Yes, prior-period information can be used, but only in very specific circumstances.

    c. Yes, prior-period information can be used, but the auditor must determine whether anything has changed.

    d. Yes, prior-period information can be used exclusively to save time performing procedures.

17. Which of the following often serves as the foundation for other risk assessment procedures?

    a. Analytical procedures.

    b. Inquiry.

    c. Inspection.

    d. Observation.

18. What guidance does the Yellow Book have for making inquiries?

    a. Inquiries made of management should be limited to information from the current year.

    b. The results of inquiries provides enough information to identify and assess risks.

    c. Inquiries about prior audits and other relevant information should be made of management.

    d. Little weight should be given to information management provides about effective fraud processes.

19. Which of the following statements best describes the use of analytical procedures during risk assessment for a HUD audit?

    a. Risk assessment procedures should not include analytical procedures as they are more appropriate during final review.

    b. Analytical procedures performed during risk assessment should be focused on the financial information pertinent to the audit.

    c. Complex mathematical and statistical models are necessary analytical procedures when performing a HUD audit.

    d. Any unusual or unexpected relationships found when performing analytical procedures may help the auditor identify risks of material misstatement.

20. Analytical procedures are most effective when they focus on which of the following?

    a. Trends that are difficult for a perpetrator to manipulate.

    b. The transactions that are easiest for the auditor to review.

    c. The exact procedures listed in AU-C 315A.

    d. Nonfinancial information.

21. Which of the following statements most accurately describes preliminary analytical procedures?

    a. The analytical procedures used during the audit cannot be updated after the preliminary planning stage.

    b. Documentation of preliminary analytical procedures should be extensive and in a formal letter to management.

    c. If results of preliminary analytical procedures reveal unusual relationships, the auditor should use these results to identify risks of material misstatements.

    d. Preliminary analytical review results must be documented on the face of the financial statements.

22. What does AU-C 240.15 require in relation to the engagement team discussion that occurs prior to a HUD audit?

    a. An open exchange of ideas.

    b. Multiple meetings for different topics.

    c. Adherence to GAAP over professional judgment.

    d. All members of the engagement team included.

23. According to AU-C 315A.33, when obtaining an understanding of a HUD entity and its environment, the auditor should document which of the following?

    a. Information on the industry and all regulations that might affect it.

    b. Every strategy and related risks that could result in noncompliance.

    c. All accounting policies selected by the HUD entity.

    d. The risk assessment procedures the auditor performed.

24. What is the most common high-risk area for HUD entities?

    a. Competition within the industry.

    b. Accounts associated with HUD funding requirements.

    c. Seasonal rental activity.

    d. Availability of credit.

25. Key performance indicators, trends, and key ratios are used to obtain an understanding of which of the following?

    a. Industry, regulatory, and other external factors.

    b. Objectives, strategies, and related business risks.

    c. Measurement and review of financial performance.

    d. Selection and application of accounting policies.

26. Which of the following indicates the risk of possible fraud related to the financial stress or dissatisfaction of employees?

    a. A long-term relationship with property management.

    b. Improvements to the employee benefit plan.

    c. Regular promotions and rewards.

    d. Anticipated layoffs.

27. Which of the following components of internal control is considered an activity-level control rather than entity-level?

    a. Control environment.

    b. Risk assessment.

    c. Monitoring.

    d. Control activities.

28. What level of understanding and knowledge must an auditor obtain of an entity's internal control and the relevant components?

    a. Minimum.

    b. Passing familiarity.

    c. Fairly thorough and robust.

    d. Full and complete.

29. How many controls should an auditor understand when obtaining an understanding of the entity's internal control?

    a. One control for each control objective.

    b. The most important controls (i.e., key controls).

    c. A certain percentage of the entity's total number of controls.

    d. All of the entity's controls.

30. Cybersecurity risks—

    a. have decreased as entities' use of digital technology has increased.

    b. can affect the risks of material misstatement in the financial statements.

    c. are not typically addressed when performing an audit engagement.

    d. usually encompass very few IT-related controls.

31. What component of internal control is the foundation for all the others?

    a. Control activities.

    b. Control environment.

    c. Information and communication.

    d. Risk assessment.

32. What term refers to an entity's financial reporting system, including the accounting system and encompassing the procedures and records established to initiate, authorize, record, process, and report transactions?

    a. Risk assessment.

    b. Oversight.

    c. Communication.

    d. Information.

33. The external and internal elements that provide a clear understanding of an entity's internal control over financial reporting and compliance are part of what process?

    a. Walkthroughs.

    b. Communication.

    c. Information.

    d. Monitoring.

34. Which of the following statements best describes the monitoring component of internal control?

    a. Virtually any activity that ensures controls are operating as intended and continue to be properly designed count as monitoring.

    b. Appropriate monitoring must take place in the form of a separate evaluation; it cannot be performed through ongoing activities.

    c. For HUD-assisted projects, monitoring is typically time intensive and will require a good deal of effort for an auditor to understand.

    d. A surface-level understanding of an entity's monitoring activities is sufficient; learning about sources of information and other issues is irrelevant.

35. What are the primary control activities that auditors need to understand when auditing a HUD-assisted project?

    a. Those related to the physical security of assets.

    b. Those concerned with the segregation of duties.

    c. Those involved with comparisons of financial reports to other information.

    d. Those concerning leasing activities and disbursements.

36. Controls that address fraud risks often relate to what two components of internal control?

    a. Control activities and control environment.

    b. Information and communication.

    c. Control activities and monitoring.

    d. Risk assessment and monitoring.

37. How do the planning decisions and judgments for the financial statement portion of a HUD audit relate to those for the compliance portion of the audit?

    a. They are completely separate processes with dissimilar steps.

    b. They are made independently, without considering the other portion of the audit.

    c. They have counterparts on either side and ought to be considered together.

    d. They are a single process with one set of steps performed simultaneously.

38. Sookie Station is a very small HUD-assisted project, while Market Projects is a large one. How would their sizes typically affect their auditors' intuitive selection of a percentage to use as a materiality benchmark?

    a. Sookie Station would have a small percentage and Market Projects a large percentage.

    b. Sookie Station would have a large percentage and Market Projects a small percentage.

    c. Both Sookie Station and Market Projects would have a large percentage.

    d. Both Sookie Station and Market Projects would have a small percentage.

39. In a financial statement audit, the greater the risks of material misstatement—

    a. the less detection risk can be accepted.

    b. the less persuasive audit evidence is needed.

    c. the less inherent and control risks exist.

    d. the less fraud risk will affect the audit.

40. What is the term for the risk that an auditor will express an inappropriate opinion on compliance in a compliance audit when material noncompliance exists?

    a. Audit risk of noncompliance.

    b. Detection risk of noncompliance.

    c. Inherent risk of noncompliance.

    d. Risk of material noncompliance.

41. Which of the following statements best describes a special planning consideration that may be necessary for a HUD audit?

    a. The risk of material misstatement or noncompliance due to fraud is eliminated if a management agent is used.

    b. The accounting personnel used by HUD-assisted projects are typically very experienced and well trained.

    c. Related party transactions are very unusual for HUD-assisted projects and, therefore, require more attention in the rare case one occurs.

    d. The calculation of tenant rental revenue is an area which may have increased risk of misstatement or noncompliance caused by error.

42. When performing a HUD audit, the initial audit strategy—

    a. must stay the same once planning is concluded and fieldwork begins.

    b. should be updated and modified as needed throughout the engagement.

    c. can only be changed after the planning period with the approval of those charged with governance.

    d. is typically complex and time consuming to prepare and, thus, should not be changed unless absolutely necessary.

43. Audit sampling rules apply when an auditor tests less than what percentage of a population and extrapolates the results to the whole population?

    a. 25%.

    b. 50%.

    c. 75%.

    d. 100%.

44. Which of the following occurs when an auditor uses a sample size of 25 rather than 60?

    a. The upper limit on the rate of misstatement is 5%.

    b. The allowable sampling risk is 10%.

    c. Tests of internal controls must be performed separately.

    d. The sample size should be expanded to 60 if a minimum of three deviations occur.

45. Can risk assessment procedures alone provide sufficient appropriate audit evidence on which to base an audit opinion?

    a. Yes, but extensive documentation of the risk assessment procedures is required.

    b. Yes, but it depends on how many relevant assertions exist.

    c. No, they must be supplemented by tests of controls, when needed, and substantive procedures.

    d. No, in a HUD audit they will not provide sufficient evidence, but they might in other types of audits.

46. According to AU-C 230.06, the document completion date occurs how long after the report release date?

    a. Within 30 days.

    b. Within 60 days.

    c. Within 90 days.

    d. Within 120 days.

47. According to Paragraph 1-5(E) of the HUD audit guide, how long should auditors retain the workpapers from the audit of a for-profit HUD entity?

    a. One year.

    b. Two years.

    c. Six years.

    d. Ten years.

48. Plum Street Apartments is a for-profit HUD entity. This year, the Mariano firm will be performing an initial audit for this project. Last year, the Forester firm performed Plum Street's HUD audit. According to the HUD audit guide, what action should Mariano take when Forester refuses to allow them access to information from last year's audit?

    a. Mariano should withdraw from the engagement immediately.

    b. Mariano should qualify their auditor's report for a scope limitation.

    c. Mariano should ask Plum Street to make arrangements with Forester in the engagement letter.

    d. Mariano can proceed without the information from Forester if control risk is under a certain threshold.

49. How can successor auditors use the predecessors' workpapers (if at all) when performing a reaudit?

    a. Successors can use predecessors' workpapers as audit evidence to support their new opinion on the financial statements.

    b. Successors can use predecessors' workpapers to lessen the amount of procedures needed in the reaudit, but only in certain, low-risk areas.

    c. Successors should review predecessors' workpapers for the reaudit period and the prior period for information useful in planning the reaudit.

    d. Successors should not look at predecessors' workpapers at all since they are reauditing the financial statements from scratch.

50. Which of the following statements best describes how group auditors might make use of the work done by component auditors?

    a. If the component auditor does not have a sufficient understanding of industry-specific knowledge, the group auditor is precluded from making reference to the component auditor's work.

    b. If the component auditor does not meet independence requirements, the group auditor cannot make reference to the component auditor's work or use that work in other ways.

    c. The group auditor does not need to obtain an understanding of the component auditor if the group auditor plans to make a reference to the audit performed by the component auditor.

    d. It is not appropriate for the group auditor to use prior experience to gain an understanding of component auditors; such an understanding must be made anew each year.

EXAMINATION FOR CPE CREDIT ANSWER SHEET

Companion to PPC's Guide to HUD Audits—Course 3—Pre-engagement Activities and Audit Planning (HUDTG223)

Name: __________

Firm Name: __________

Firm Address: __________

City: __________ State/ZIP: __________

Firm Phone: __________ Firm Fax No.: __________

Firm Email: __________

Signature: __________

Credit Card Number: __________ Expiration Date: __________

Birth Month: __________ Licensing State: __________

ANSWERS:

This answer sheet and the following evaluation can be printed. If filling out a printed version, please indicate your answers for each question by filling in the appropriate circle as shown: Fill in like this: ● not like this: ⦸ ⊗ ✓

You must complete the entire course to be eligible for credit.

	a	b	c	d		a	b	c	d		a	b	c	d		a	b	c	d
1.	○	○	○	○	14.	○	○	○	○	27.	○	○	○	○	39.	○	○	○	○
2.	○	○	○	○	15.	○	○	○	○	28.	○	○	○	○	40.	○	○	○	○
3.	○	○	○	○	16.	○	○	○	○	29.	○	○	○	○	41.	○	○	○	○
4.	○	○	○	○	17.	○	○	○	○	30.	○	○	○	○	42.	○	○	○	○
5.	○	○	○	○	18.	○	○	○	○	31.	○	○	○	○	43.	○	○	○	○
6.	○	○	○	○	19.	○	○	○	○	32.	○	○	○	○	44.	○	○	○	○
7.	○	○	○	○	20.	○	○	○	○	33.	○	○	○	○	45.	○	○	○	○
8.	○	○	○	○	21.	○	○	○	○	34.	○	○	○	○	46.	○	○	○	○
9.	○	○	○	○	22.	○	○	○	○	35.	○	○	○	○	47.	○	○	○	○
10.	○	○	○	○	23.	○	○	○	○	36.	○	○	○	○	48.	○	○	○	○
11.	○	○	○	○	24.	○	○	○	○	37.	○	○	○	○	49.	○	○	○	○
12.	○	○	○	○	25.	○	○	○	○	38.	○	○	○	○	50.	○	○	○	○
13.	○	○	○	○	26.	○	○	○	○										

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Course Title: Companion to PPC's Guide to HUD Audits—Course 3—Pre-engagement Activities and Audit Planning (HUDTG223)

Your Name (optional): ______________________ Date: ______________

Email: ______________________________

Please indicate your answers by filling in the appropriate circle as shown:
Fill in like this: ● not like this: ⦶ ⊗ ✓

Satisfaction Level:	Low (1) . . . to . . . High (10)									
	1	2	3	4	5	6	7	8	9	10
1. How would you rate the appropriateness of the course materials for your experience level?	○	○	○	○	○	○	○	○	○	○
2. How would you rate the examination related to the course content?	○	○	○	○	○	○	○	○	○	○
3. Does the examination consist of clear and unambiguous questions and statements?	○	○	○	○	○	○	○	○	○	○
4. Were the stated learning objectives met?	○	○	○	○	○	○	○	○	○	○
5. Were the course materials accurate and useful?	○	○	○	○	○	○	○	○	○	○
6. Were the course materials relevant, and did they contribute to the achievement of the learning objectives?	○	○	○	○	○	○	○	○	○	○
7. Was the time allotted to the learning activity appropriate?	○	○	○	○	○	○	○	○	○	○

Please enter the number of hours it took to complete this course. ______________

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Additional Comments:

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2. What did you find **least** helpful?
3. What other courses or subject areas would you like for us to offer?
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GLOSSARY

Audit plan: Also called an *audit program*, this is more detailed than the *audit strategy* and documents the nature, timing, and extent of procedures to be performed to obtain sufficient appropriate audit evidence.

Audit risk: In a financial statement audit, this is the risk that the auditor may unknowingly fail to appropriately modify his or her opinion on financial statements that are materially misstated. It is a function of the risk that the financial statements are materially misstated and the risk that the auditor will not detect such material misstatement.

Audit risk of noncompliance: The risk of an auditor expressing an inappropriate opinion on compliance when material noncompliance exists. It is a function of the *risk of material noncompliance* and the *detection risk of noncompliance*.

Audit sampling: The selection and evaluation of less than 100% of a population such that the auditor can reasonably expect the items in the sample to be representative of the population and likely to provide a reasonable basis for conclusions about the population.

Audit strategy: The auditor's operational approach to achieving the objectives of the audit. A high-level description of the audit scope, timing, and direction.

Clearly trivial misstatements: Misstatements that are not required to be accumulated and evaluated if detected during the audit. This is also called the *nonposting threshold*. This amount is set so that any such misstatements, either individually or when aggregated with other such misstatements, would not be material to the financial statements after the possibility of further undetected misstatements is considered.

Communication: This component of internal control is the process of providing an understanding of roles and responsibilities to individuals within the entity regarding internal control over financial reporting. It is part of the same component as *information*.

Component: An entity or business activity for which group or component management prepares financial information that is required by the applicable financial reporting framework to be included in the *group financial statements*.

Component auditor: An auditor who performs work on the financial information of a *component* that will be used as audit evidence for the group audit.

Control activities: This component of internal control is the policies and procedures that help ensure that management directives are carried out. They are those actions that are taken to address risks that threaten the entity's ability to achieve its objectives, one of which is reliable financial reporting.

Control environment: This component of internal control sets the tone of an entity and influences the control consciousness of its people. It provides the foundation for all other components of internal control. It includes the attitude, awareness, and actions of management, as well as those charged with governance, concerning internal control.

Control risk: The risk that a misstatement that could occur in an assertion about a class of transaction, account balance, or disclosure and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Control risk of noncompliance: The risk that noncompliance with a compliance requirement that could occur and that could be material to a major program, either individually or when aggregated with other instances of noncompliance, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control over compliance.

Cybersecurity risk: The risk that an attack or intrusion of the IT platform will be successful and that there will be a breach in these controls and a cyber incident.

Detection risk: The risk that the procedures performed by the auditor to reduce *audit risk* to an acceptably low level will not detect a misstatement that exists and that could be material, either individually or when aggregated with other misstatements.

Detection risk of noncompliance: The risk that the procedures performed by the auditor to reduce *audit risk of noncompliance* to an acceptably low level will not detect noncompliance that exists and that could be material, either individually or when aggregated with other instances of noncompliance.

Governing documents: Legal documents that create a HUD entity or stipulate how it should be operated under HUD regulations. Most HUD entities have agreements for (1) the formation of the entity, (2) a Regulatory Agreement, (3) an Affirmative Fair Housing Marketing Plan, (4) a management agreement, (5) a Management Entity Profile, and (6) the Housing Assistance Payments (HAP) contract.

Group financial statements: Financial statements that include the financial information of more than one *component*.

Information: This component of internal control refers to the financial reporting system, which includes the accounting system and encompasses the procedures and records established to initiate, authorize, process, and report the HUD project's transactions. It also includes accountability over the assets, liabilities, and equity. An information system may be automated, manual, or a combination of the two depending on the size and complexity of the entity. It is part of the same component as *communication*.

Inherent risk: The susceptibility of an assertion about a class of transaction, account balance, or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls.

Inherent risk of noncompliance: The susceptibility of a major program's compliance requirement to noncompliance that could be material, either individually or when aggregated with other instances of noncompliance, before consideration of any related controls over compliance.

Market rent: A rent payment calculated by the owner of a HUD entity based on a mortgage that carries a market interest rate.

Monitoring: This component of internal control is a process by which an entity assesses the quality of its internal control over time. It involves assessing the design and operation of controls on a timely basis, capturing and reporting identified control deficiencies, and taking actions as necessary. Monitoring activities can also reveal evidence or symptoms of fraud.

Nonsupervisory auditors: Auditors in these roles plan or perform engagement procedures. Work situations for these auditors are characterized by low levels of ambiguity, complexity, and uncertainty. The nonsupervisory role necessitates at least a basic level of proficiency.

Partners and directors: Auditors in these roles plan engagements, perform engagement procedures or direct or report on engagements. Partners and directors may also be responsible for reviewing engagement quality prior to issuing reports, for signing the report, or both. Work situations for these auditors are characterized by high levels of ambiguity, complexity, and uncertainty. The partner and director role necessitates an advanced level of proficiency.

Performance materiality: The amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole. When applicable, it also refers to the amount or amounts set by the auditor at less than the materiality level(s) for particular classes of transactions, account balances, or disclosures.

Planning materiality: An auditor's preliminary judgment about materiality at the financial statement level. The auditor uses the concept of materiality both in (1) planning and performing the audit (*planning materiality*) and (2) evaluating the effect of identified misstatements on the audit and the effect of uncorrected misstatements on the financial statements (*evaluation materiality*).

Predecessor auditor: An auditor from a different firm who reported on the most recent audited financial statements or was engaged to perform but did not complete an audit of the financial statements. That may include an auditor who was engaged to perform an initial audit but did not complete the audit. It may also include an auditor who was engaged subsequent to the most recent audited financial statements who did not complete the audit. In the latter case, there may be two predecessor auditors—the auditor who reported on the most recent audited financial statements and the successor auditor who did not complete the audit.

Presumptively mandatory requirements: In GAAS and the Yellow Book, these requirements are identified by the word "should." Auditors must comply with them if the circumstances apply to the requirement. However, in rare situations (unlike with *unconditional requirements*), a departure from the requirement is allowed if the auditor documents the justification and how alternative procedures that were performed were sufficient to achieve the intent of the requirement.

Reaudit: When an auditor is asked to audit and report on an entity's financial statements for a period that was previously audited and reported on by a predecessor auditor.

Risk assessment: This component of internal control is the process of setting objectives; prioritizing and linking those objectives; and identifying, analyzing, and managing risks relevant to achieving those objectives.

Risk of material misstatement: This is the risk that the financial statements are materially misstated prior to the audit. It consists of two components—*inherent risk* and *control risk*.

Risk of material noncompliance: This is the risk that material noncompliance exists prior to the audit. It consists of two components—*inherent risk of noncompliance* and *control risk of noncompliance*.

Safeguards: Actions or measures designed, individually or in the aggregate, to eliminate *threats to independence* or reduce them to an acceptable level.

Significant components: *Components* that are (1) of individual financial significance to the group or (2) due to their specific nature or circumstances, are likely to include significant risks of material misstatement of the group financial statements.

Supervisory auditors: Auditors in these roles plan engagements, perform engagement procedures, or direct engagements. Work situations for these auditors are characterized by moderate levels of ambiguity, complexity, and uncertainty. The supervisory auditor role necessitates at least an intermediate level of proficiency.

Threats to independence: Circumstances or activities that could, but do not necessarily, impair independence. They may be created by a wide range of relationships and circumstances and should be evaluated for any activity not specifically prohibited in the Yellow Book.

Tolerable misstatement: The application of *performance materiality* to a particular audit sampling procedure. It is an amount the auditor sets to obtain an appropriate level of assurance that the amount will be less than the actual misstatement in the population.

Unconditional requirements: In GAAS and the Yellow Book, these requirements are identified with the words "must" or "is required." Auditors must follow these requirements in all cases if the circumstances apply to the requirement.

Walkthroughs: Tracing a transaction through the various processing steps and related to controls from initiation to inclusion in the general ledger and the financial statements.

INDEX

This index is a list of general topics discussed in the course. More specific key word searches can be performed using the search feature of this PDF.

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